# COMPLIANCE GAP

## HEARING

BEFORE THE

## SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

MARCH 22, 1982

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# COMPLIANCE GAP

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MONDAY, MARCH 22, 1982

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE,
SENATE FINANCE COMMITTEE,
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10:11 a.m., in room 2221, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman) presiding.

Present: Senators Dole, Grassley, and Baucus.

Also present: Senators Chafee and Symms.

[The press release announcing hearings, background material relating to S. 2198, the Taxpayer Compliance Improvement Act of 1982, and the prepared statements of Senators Dole and Grassley follow:]

[Press release No. 82-111, Subcommittee on Oversight of the Internal Revenue Service, Mar. 9, 1982]

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SETS HEARING ON COMPLIANCE GAP

Senator Charles E. Grassley, (R., Iowa), Chairman of the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance, announced today that the Committee will hold a hearing on March 22 on the compliance gap and the Dole-Grassley compliance proposals. A summary of those proposals is attached hereto.

The hearing will begin at 10 a.m. in room 2221 of the Dirksen Senate Office Building.

*Requests to testify.*—Chairman Grassley requested that persons wishing to testify must submit written requests to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than noon on Wednesday, March 17, 1982. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such a case, a witness should notify the Committee as soon as possible of his inability to appear.

*Consolidated testimony.*—Senator Grassley urges all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Committee. This procedure will enable the Committee to receive a wider expression of views than they might otherwise obtain. Senator Grassley urges that all witnesses exert a maximum effort to consolidate and coordinate their statements.

*Legislative Reorganization Act.*—Senator Grassley stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

# BACKGROUND ON FEDERAL INCOME TAX COMPLIANCE AND DESCRIPTION OF S. 2198 (TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1982)

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PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

## INTRODUCTION

The Senate Finance Subcommittee on Oversight of the Internal Revenue Service has scheduled a public hearing on March 22, 1982, on Federal income tax compliance and on S. 2198 (Senators Dole, Grassley, Chafee, Domenici, Danforth, Stafford, and Andrews) which would address certain taxpayor compliance shortcomings.

This pamphlet, prepared in connection with the Subcommittee's hearing, contains five parts. First, there is an overview of the income tax compliance scheme established in the Internal Revenue Code. Secondly, administrative efforts by the Internal Revenue Service to promote compliance are summarized. Thirdly, current and historical data are presented on the level of voluntary compliance for different segments of the taxpaying population. Fourthly, different approaches toward increasing taxpayor compliance are identified and discussed. Finally, a section-by-section description of the bill, S. 2198 (the Taxpayer Compliance Improvement Act of 1982) is provided.

# I. PROVISIONS OF PRESENT LAW RELATING TO COMPLIANCE WITH THE FEDERAL INCOME TAX LAWS

## A. Overview

The internal revenue laws impose income taxes on individuals, estates, trusts, corporations and other organizations. These taxes are levied and collected under a system of self-assessment which requires taxpayers to file returns reporting income, deductions, credits, and other information necessary to compute tax liability. This system covers domestic as well as foreign transactions.

To assure compliance with the self-assessment system, the tax law imposes a variety of requirements both on taxpayers and on persons making payments to third parties. These include minimum filing requirements, recordkeeping requirements, withholding tax requirements, estimated tax payment requirements, and information reporting requirements. Taxpayers who fail to pay tax or who underpay their tax are subject to interest charges and may incur penalties. Similarly, failure to file required information returns and statements may result in imposition of penalties. These requirements and the consequences of noncompliance are described below.

In addition, non-tax reporting requirements are imposed by the Bank Secrecy Act on financial institutions receiving large cash deposits from individuals, and on persons who bring large amounts of cash into or out of the United States.

## B. Filing Requirements

Any person subject to any tax, or required to collect and pay over any tax, must make such returns, file such statements and provide such information as may be required by Treasury regulations. Such returns or statements must be according to the forms prescribed, and contain the information required by the Treasury including employer account numbers and employee identification numbers.

### *1. Individuals*

As a general rule, every individual who is a United States citizen or resident who has gross income for the taxable year equal to or greater than the sum of the zero bracket amount applicable to that taxpayer plus the exemption amount ($1,000 under present law) must file an income tax return, even if the tax has been paid by installment or withholding payments. For example, individuals who are not married and not surviving spouses and who have gross income for the taxable year of $3,300 or more (the sum of the exemption amount, $1,000, plus the zero bracket amount applicable to such an individual, $2,300) must file income tax returns. Similarly, filing is required of individuals entitled to file jointly with their spouses and whose gross income, when combined, is equal to $5,400 (i.e., the zero bracket amount applicable to a joint return ($3,400) plus twice the exemption amount ($2,000)). If a taxpayer is entitled to an additional exemption amount for being 65 or over, for example, the filing threshold is increased accordingly.

These filing thresholds for individuals do not apply to nonresident alien individuals, United States citizens entitled to the benefits of section 931 with respect to income from sources within United States possessions, individuals making short-year returns with respect to changes in accounting periods, and certain dependents who have unearned income. Such persons are subject to specialized filing rules or may not be required to file at all.

Minors are subject to the same filing requirements as are other individuals. The return of a minor must be made by the minor himself or by his guardian or the persons charged with the care of the minor's person or property.

A tax return may be made by the taxpayer's agent if, by reason of disease or infirmity, the person liable for the return is unable to make it, or if the taxpayer is continuously absent from the United States (including Puerto Rico) for a period of at least 60 days prior to the return due date. The return may also be made by an agent if the district director determines that good cause exists for permitting the return to be made by an agent.

In general, every nonresident alien individual engaged in a trade or business in the United States at any time during the taxable year, or who has taxable income for the taxable year (unless fully paid by withholding) must make a return of income.

### 2. Corporations

Every domestic corporation (other than exempt corporations) in existence during any portion of a taxable year must file an income tax return. If a corporation is in existence for only part of a taxable year, it is required to make a return for that part of the taxable year. If an organization is otherwise exempt from tax under section 501(a) (dealing with certain exempt organizations), but is liable for the tax imposed on unrelated business income, it must nonetheless make a return.

In addition, every foreign corporation engaged in a trade or business in the United States at any time during the taxable year or which has income subject to tax for the taxable year (unless fully paid by withholding) must make a return of income.

### 3. Fiduciaries

The income tax return of taxable estates and trusts must be filed by the fiduciary responsible for the estate and trust. Tax returns are required if the estate or trust has $600 or more of gross income during the taxable year or if any beneficiary of the estate or trust is a nonresident alien. Generally, no income tax return is required for a trust described in section 501(a), unless the trust is liable for the tax on unrelated business income. In addition, certain U.S. beneficiaries of foreign trusts are required to report their interests in the trust, and foreign trusts with U.S. beneficiaries must report.

### 4. Consequences of failure to file and pay tax

In general, the Secretary is required to make any inquiries and determinations necessary to assess all taxes imposed under the Internal Revenue Code. If a taxpayer fails to report and pay income, estate, gift, and certain excise taxes due, the Commissioner is authorized to send a notice of deficiency to the taxpayer and to proceed with the various steps preparatory to assessment and collection of the tax.

Various additions to tax, assessable civil and criminal penalties also attend the failure to file a timely, an accurate tax or information return or statement and to pay on time any tax due. These include penalties for failure to file or pay tax, negligence and fraud, which are described below. The separate penalties for failure to collect and pay over witholding taxes are described in Section C.2. below.

#### *Failure to file return or to pay tax*

Any failure to file an income, estate, or gift tax return or to pay the amount shown as tax thereon on the due date (including extensions), may result in an addition to tax (sec. 6651). The penalty for failure to file on time, is an addition to tax equal to five percent of the amount of tax required to be shown on the return for each month or fraction thereof that the failure continues, but not in excess of 25 percent. A failure to timely pay the amount shown as tax on the return will result in an addition to tax equal to 0.5 percent of the amount of such tax for each month or a fraction thereof that the failure continues, not exceeding 25 percent. These additions to tax do not apply if the failure to file or pay is due to reasonable cause and not to willful neglect. In either case the penalty is computed on the net amount due the Treasury. Thus, there is no penalty for failure to file if no tax is owed in excess of amounts withheld or paid as estimated tax. These penalties do not apply to any failure to file a declaration of estimated tax or to pay any estimated tax. Those failures are subject to separate penalties. (See D., below.) The failure to pay penalty reduces any addition to tax for failure to file.

There is also an addition to tax for failure to file certain information returns. Any failure to file the information returns required with respect to, for example, interest and dividends will result in a $10 penalty per failure not to exceed $25,000 for the calendar year (sec. 6652). There is a similar penalty for failure to provide a required information statement to the payee. Both penalties are subject to a reasonable cause defense.

Further, any person who is required to provide a taxpayer identification number to the Secretary or another person and who fails to do so is subject to a $5 penalty for each failure, subject to a reasonable cause exception.

*Negligence*

If any part of an underpayment of income, gift, or windfall profit tax is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there is added to the tax an amount equal to 5 percent of the total underpayment. In addition, there is added to the tax an amount equal to 50 percent of interest payable with respect to that portion of the underpayment attributable to negligence or intentional disregard of rules and regulations (sec. 6653(a)).

*Fraud*

If any part of an underpayment of any tax is due to fraud, there is added to the tax an amount equal to 50 percent of the entire underpayment (sec. 6653(b)). In the case of any income or gift tax, the negligence penalty does not apply if the fraud penalty applies. In addition, if a fraud penalty is assessed for any underpayment, no penalty for failure to file or pay tax will be assessed for that underpayment. In addition to the 50-percent civil fraud penalty, criminal penalties may apply. (See paragraph (e) below.)

*Jeopardy and termination assessments*

In addition to the normal deficiency procedure which is available to the Internal Revenue Service for the collection of underpayments, the Internal Revenue Service has other tools at its disposal for the collection of tax, including the jeopardy and termination assessment procedures of income taxes.

The Secretary may make a jeopardy assessment of income, estate, gift, and certain excise taxes if he determines that there is a deficiency the collection of which would be jeopardized by delay. In the case of a jeopardy assessment, the Secretary may immediately assess and collect such deficiency, together with all interest, additional amounts, and additions to tax provided for by law without prior notice (sec. 6861). A jeopardy assessment may be made at any time prior to the earlier of a final decision of the Tax Court or the appeal of a Tax Court decision. There are provisions for the abatement of any jeopardy assessment and for review.

The Secretary may make a termination assessment if he finds that a taxpayer intends to do any act tending to render proceedings to collect the income tax for the current or immediately preceding taxable year ineffectual (sec. 6851). When a termination assessment is made with respect to the current taxable year, the Secretary must treat that taxable year as terminated as of the date of the determination and treat that portion of the taxable year as if it were an entire taxable year. The amount assessed is due and payable immediately. Termination assessments are subject to review by the Tax Court. The Secretary may not make a termination assessment for the taxpayer's preceding taxable year after the due date for that year's return.

### *Criminal penalties*

There are certain criminal penalties which attend a failure to file an income tax return as required or to pay a tax when due. For example, any person who willfully attempts to evade or defeat any tax is guilty of a felony and is subject to a fine of not more than $10,000 or imprisonment for not more than 5 years, or both (sec. 7201). If a person is required to pay a tax, including estimated tax, to make a return, to keep any records, or to supply any information and that person willfully fails to do so, then that person is guilty of a misdemeanor and is subject to a fine of not more than $10,000 or imprisonment for not more than one year, or both (sec. 7203). The penalty for perjury on a tax return is a fine of not more than $5,000 or imprisonment for not more than 3 years, or both. A person, who willfully aids, counsels or advises the preparation of a fradulent return or other document, is guilty of a felony and may be subject to a fine of not more than $5,000 or prison for not more than three years, or both (sec. 7206).

## C. Withholding and Withholding Noncompliance

### *1. Withholding requirements*

Under present law, an employer who pays wages to individual employees (or has employees who report tips) must withhold a portion of such wages to satisfy all, or part, of the employee's Federal income tax liability (sec. 3402). The term "wages" generally is defined as all remuneration, unless specifically excluded, paid for services performed by an employee for an employer, including the cash value of all remuneration paid in any medium other than cash (sec. 3401(a)).

The amount to be withheld from the wages of a particular employee is determined in accordance with tables prescribed by the Secretary. Except in the case of certain foreign persons, there is no requirement under present law for withholding on payment other than wages.

#### *Withholding exemptions*

Individuals whose wages are subject to withholding may be entitled to exempt them from withholding in $1,000 increments (exemptions). The exemptions allowed include (1) one exemption for the taxpayer; (2) one additional exemption for the taxpayer who has attained, or will attain, age 65 during the taxable year; (3) one additional exemption if the taxpayer is blind; (4) an exemption for the taxpayer's spouse (and additional exemptions for age or blindness of the spouse) unless the spouse is claiming the exemptions on a separate return; (5) one additional exemption for each dependent of the taxpayer; and (6) a zero bracket amount allowance, unless the taxpayer is married and the spouse receives wages subject to withholding or the taxpayer has withholding exemption certificates in effect with respect to more than one employer. In addition to these withholding exemptions, taxpayers may be entitled to claim additional withholding exemptions for excess itemized deductions, tax credits and additional items specified in Treasury Regulations.

An individual subject to withholding may reduce or increase the number of exemptions claimed (under procedures set forth in the regulations) so that withheld taxes will more closely equal his or her anticipated tax liability. Employees who incurred no income tax liability for the preceding taxable year and expect to have no income tax liability for the current taxable year may claim total exemption from wage withholding.

#### *Withholding exemption certificates*

An individual may claim withholding exemptions by furnishing his or her employer with a withholding exemption certificate (Form W-4). In the case of new employment, this certificate must be furnished on or before employment begins. If no exemption certificate is furnished, the employee is considered as unmarried and claiming no exemptions.

When a change occurs which decreases the number of withholding exemptions which an employee is entitled to claim, the employee must furnish the employer with a new exemption certificate reflecting the correct number of exemptions. Such new certificate must be furnished within ten days after the change occurs. In addition, a new certificate is required when an employee who has claimed complete exemption from withholding can no longer reasonably anticipate a zero income tax liability for the current taxable year.

An employer is required to submit to the Internal Revenue Service a copy of a withholding exemption certificate received from an employee during the reporting period if (1) on the last day of the reporting period, the employee is employed by that employer and claims more than fourteen withholding exemptions, or (2) the employee claims complete exemption from withholding unless the employer reasonably expects that the employee's wages from the employer will not usually exceed $200 a week.

### *Voluntary withholding*

Under present law, annuity or pension payments are subject to withholding to the extent includible in gross income if the payee so requests (sec. 3402(o)(1)(B)). Such request must be made in writing to the payor of the annuity or pension.

The amount requested to be withheld from a pension or annuity must be at least $5 per month and must not reduce the net amount of any pension or annuity payment below $10.

### *Withholding on gambling winnings*

In certain circumstances, proceeds from wagers are subject to withholding at a rate of 20 percent (sec. 3402(q)). In general, gambling winnings are subject to withholding if the proceeds exceed $1,000 and are at least 300 times as large as the amount wagered. However, special rules apply to winnings from State-conducted lotteries and winnings from sweepstakes, wagering pools, certain parimutuel pools, jai alai, and other lotteries.

The payor of gambling winnings that are subject to withholding is required to file Form W-2G with the internal revenue service center serving the district in which the principal place of business of the person filing the return is located.

### *Withholding on foreign investors*

In general, the United States taxes U.S. source income of a nonresident alien or foreign corporation which is not effectively connected with the conduct of a trade or business in the United States at a flat rate of 30 percent (or a lower treaty rate) of the gross amount paid. This tax is collected through withholding by the person making the payment to the foreign recipient. Income effectively connected with a U.S. trade or business is not subject to the flat 30-percent withholding tax, but instead is includable in the U.S. income tax return of the business and is taxed at the regular graduated rates (and is not subject to withholding at source).

Certain noneffectively connected U.S. source income is exempt from U.S. tax, and therefore withholding. For example, interest from bank deposits, and original issue discount on obligations maturing in six months or less. Also, the income of foreign governments from investments in the United States in bonds, stocks, and other securities, or from interest on bank deposits, is exempt from U.S. tax.

*2. Consequences of withholding noncompliance*

In general, any person required to collect and pay over any tax who willfully fails to do so or who willfully attempts to evade or defeat the tax is liable for a penalty equal to the total amount of the tax evaded, not collected, or not accounted for and paid over (sec. 6672).

Any person required to deposit a tax by a prescribed date who fails to do so, or any person who makes an overstated deposit claim, is subject to a penalty equal to 5 percent of underpayment or 25 percent of the overstatement, as the case may be, unless the failure or overstatement was due to reasonable cause and not willful neglect. (sec. 6656).

Any person who is required to furnish certain information to employees with respect to withholding of tax, and who willfully fails to do so or furnishes a false or fraudulent statement, is liable for a penalty of $50 for each failure (sec. 6674). In addition, such a person may be subject to a criminal penalty of up to $1,000 or may be imprisoned for not more than one year, or both (sec. 7204).

In addition, any individual who makes a false withholding statement may be subject to civil penalty of $500, (1) if such statement results in a decrease in the amount deducted and withheld, and (2) if at the time the statement was made there was no reasonable basis for such statement. The Secretary may waive this penalty (in whole or in part) if the taxes imposed on the individual are equal to or less than the sum of his credits against taxes and payments of estimated taxes (sec. 6682). Such individual may also be subject to a criminal penalty of not more than $1,000 or imprisonment of not more than 1 year, or both (sec. 7205).

## D. Estimated Tax

### *1. Corporations*

Any corporation subject to tax is required to make payments of estimated tax if it reasonably expects to have a tax liability for the taxable year of $40 or more. The estimated tax is payable in up to four installments over the taxable year. In general, if the estimated tax payments for the taxable year are not at least 80 percent of the actual tax due, then a penalty is imposed as an addition to tax. This penalty equals the amount of interest which would accrue on the amount of the underpayment of estimated tax during the period of the underpayment. Generally, this addition to tax does not apply with respect to any installment if, on or before the date prescribed for such installment, the corporation pays the amount which would have been due on that date if the estimated tax were the lesser of:

(1) The corporation's prior year tax liability;

(2) the corporation's tax liability on prior year's income computed using tax rates for the current year; or

(3) 80 percent of the taxes which would have been due if the income which the corporation had already received during the current year had been computed on an annualized basis.

In 1982 and 1983, large corporations (those with taxable income of $1,000,000 or more during any of the three previous taxable years) otherwise qualifying for treatment under either of the first two safe harbors will not be subject to the addition to tax if their estimated tax payments for the taxable year are at least 65 percent (in 1982) or 75 percent (in 1983) of the tax shown on their returns for that taxable year. In 1984 and thereafter, the first two safe harbor rules are not available to large corporations. In 1984 and thereafter, therefore, a large corporation must either pay at least 80 percent of the amount of tax shown on its return for the taxable year, or 80 percent of the taxes which would have been due if the income which the corporation had already received during the current year had been computed on an annualized basis.

### *2. Individuals*

Individuals must also declare and pay estimated tax. In general, a single person, or a married couple with one wage earner, whose gross income is expected to exceed $20,000 for the taxable year is liable to declare and pay estimated tax. A married individual entitled to file a joint return with his spouse, whose gross income is expected to exceed $10,000 for the taxable year, and whose spouse also receives wages is also liable to declare and pay such tax. Finally, a married individual not entitled to file a joint return with his or her spouse, whose gross income is expected to exceed $5,000, must declare and pay estimated tax. However, an individual who expects to receive more than $500 from sources other than wages during the year must declare and pay estimated tax. Regardless of the taxpayer's estimated income, however, no declaration of estimated tax is required if it is anticipated that the taxpayer's estimated tax liability for the year will be less than $200 (or $300 for 1983, $400 for 1984, and $500 for 1985 and thereafter).

An individual who fails to pay an amount of estimated tax due on or before the due date may be subject to a penalty. The penalty is equal to the amount of interest which would accrue on the underpayment during the period of the underpayment. In general, an underpayment for this purpose is equal to the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year, divided by the number of installments that should have been paid. The penalty is not subject to a reasonable cause defense.

There are four exceptions to the general underpayment penalty. No underpayment penalty is imposed upon a taxpayer if: (1) total tax payments for the current year equal or exceed the amount due if the current year's tax equaled the tax shown in the preceding year's return, or the preceding year's tax liability, if no return showing a liability for tax was filed for the preceding year; (2) total tax payments equal or exceed 80 percent of the taxes which would be due if the income already received during the current year were placed on an annual basis; or (3) total tax payments equal or exceed 90 percent of the tax which would be due on the income actually received from the beginning of the year to the computation date; or (4) total estimated tax payments equal or exceed the amount due at current year's rates and exemptions, but otherwise based on the preceding taxable year's law and income.

In 1985 and subsequent years no penalty will be imposed upon an individual for failure to pay estimated tax if the tax shown on the individual's return (or, if no return is filed, the tax) is less than $500. This exception to the penalty for failure to pay estimated taxes is phased in in the same manner as the increase in the tax liability threshold.

## E. Information Reporting

### *1. Information at source generally*

Under present law, persons (other than corporations) engaged in a trade or business, and the United States, must generally file information returns with respect to payments aggregating $600 or more in any taxable year (sec. 6041(a)). These returns are intended to inform the Internal Revenue Service that specified items have been disbursed by the payor so that the Service can determine whether the recipient of the item has treated it properly for tax purposes.[1] This reporting requirement, subject to various exceptions, applies to various payments including rent, salaries, wages, commissions, fees, or other forms of compensation for services, and other fixed or determinable gains, profits, or income, regardless of medium in which payment is made.

These information returns are required to be filed annually and generally must contain the name, address, and tax identification number of the recipient of the payment (secs. 6041(a) and 6109(a)). Likewise, the payor must furnish the recipient with a written statement showing the payor's name, address, and taxpayer identification number, and the aggregate amount of payments shown on the return. Such statement must be furnished to the recipient on or before January 31 of the year following the calendar year for which the return was made (sec. 6041(d)).

Generally, amounts paid to employees, regardless of whether they are subject to withholding, are not reportable on the usual information return (Form 1099). Instead, those amounts are reportable on information returns (Form W-2) which relate to payments to employees.

Partnerships are required to file returns for each taxable year stating such items as the Secretary may prescribe, including items of gross income and deductions, and the names and addresses of each individual partner and the amount of that partner's distributive share (sec. 6031). If the partnership fails to file such a return, or files an incomplete return, it will be liable for a penalty equal to $50 per partner per month (for not more than 5 months) that the failure continues (sec. 6698). In addition, a criminal penalty may apply (sec. 7203).

Various reporting requirements are also imposed upon the other entities, including custodians of common trust funds, exempt organizations, officers of foreign personal holding companies, and subchapter-S corporations.

[1] The Internal Revenue Service's Information Returns Program (IRP) matches the information returns filed with respect to payments to some individuals with their income tax returns to detect nonfiling or underreporting of income. Under this program, most information returns filed for individuals on magnetic tape, and some of those filed on paper forms, are included in the IRS document matching program.

*2. Payments of dividends*

Present law imposes information reporting requirements with respect to payments of dividends (sec. 6042). In general, every person who makes dividend payments aggregating $10 or more to any other person in a calendar year, including dividends received as nominee, must file information returns with the Secretary. In the case of the payment of dividends aggregating less than $10, the requirement of information reporting is discretionary with the Secretary.

Dividend information returns must be filed with the Internal Revenue Service after September 30 for any calendar year, but not before the payor's final dividend payment for that year, and on or before February 28 of the following year. The returns must set forth the aggregate amount of dividend payments and the name and address of the person to whom paid.

In addition to filing information returns with the Internal Revenue Service, payors of dividends also must furnish statements to recipients of the dividends. These statements must set forth the name and address of the payor of the dividends and the aggregate amount of payments made to the dividend recipient. Such a statement must be furnished to a dividend recipient no later than January 31 of the year following the dividend payment.

For purposes of this information reporting requirement, the term "dividend" means any distribution made by a corporation which is a dividend under section 316 of the Code. The term dividend also includes any payment made by a stockbroker to any person as a substitute for a dividend, for example, a payment made on a short sale.

The dividend reporting requirements generally do not apply to distributions or payments made by foreign corporations, distributions or payments made to foreign corporations, nonresident aliens, or partnerships not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens. Also excluded from the reporting requirements is the undistributed taxable income of electing small business corporations.

If the payor is unable to determine what portion of a payment represents a dividend or is paid with respect to a dividend, then, for purposes of the information return requirements, the entire amount of the payment is considered to be a dividend or a payment with respect to a dividend.

*3. Payments of interest*

The information reporting requirements for interest payments are similar to the requirements imposed on dividend payments (sec. 6049). In general, every person who makes interest payments, whether as a principal or nominee, aggregating $10 or more to any other person during the calendar year must file an information return. In addition, a corporation which issues a bond or other evidence of indebtedness in registered form after May 27, 1969 (unless issued pursuant to a written commitment binding on and after that date), must file an information return if, during the calendar year, an amount of original issue discount aggregating $10 or more is includible in the gross income of any holder. In the case of the interest payment aggregating less than $10, the information reporting requirement is discretionary with the Secretary. The Secretary also has discretion to require information reporting with respect to corporate interest payments such as on bearer instruments.

Information returns for the payment of interest must be filed with the Internal Revenue Service after September 30 for the calendar year, but not before the payor's final payment for the year, and on or before February 28 of the following year. These returns must set forth the aggregate amount of the interest payments to any taxpayer and the name and address of the person to whom paid.

Information returns required with respect to original issue discount must be filed with the Service after December 31 for the calendar year in which the original issue discount accrues, and on or before February 28 of the following year. In general, these returns must set forth various information, including the aggregate amount includible in income by each holder of a discount obligation for the period during the calendar year in which the obligation was held; the ratable monthly portion of original issue discount; the issue price of the obligation; and the stated redemption price at maturity.

Payors of interest and persons who are required to file information returns with respect to original issue discount must furnish statements to recipients setting forth the aggregate amount of interest payments or original issue discount includible in income. Statements to recipients of interest must be furnished after November 30 (but not before the final interest payment for the year) of the calendar year and on or before January 31 of the following year. These statements may be furnished at any time after April 30 of the calendar year of payment if furnished with the final interest payment for the calendar year. Statements for original issue discount must be furnished after December 31 and on or before January 31.

Included in the term "interest," for purposes of these reporting requirements are: (1) interest on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a corporation in registered form and, to the extent prescribed by regulations, interest on other corporate indebtedness issued to the public (e.g., bearer bonds); (2) interest on bank deposits; (3) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchaseable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; and (5) interest on deposits with stockbrokers and dealers in securities.

### *4. Employee tips*

Under present law (sec. 6053(a)), an employee who receives and retains tips of $20 or more in a month, including charge tips paid over to the employee by the employer, must report such tips to his or her employer by the tenth day of the following month. If an employee fails to report any amount of such tips to his or her employer, a penalty is imposed on the employee equal to 50 percent of the social security or railroad retirement tax, as the case may be, imposed with respect to the amount of the tips which he failed to report (sec. 6652(c)).

In turn, employers are required to report as wages subject to income tax withholding and social security withholding only the tips actually reported to them by their employees pursuant to section 6053(a).[2] The present law for both income tax withholding and social security withholding refers to the amount of tips reported by the employee to the employer under section 6053(a) as the amount of tips which constitute wages for purposes of the withholding requirements.

Section 6041(e) specifically provides that the information reporting requirements do not apply to tips that are reportable under section 6053(a). This provision, enacted by the Revenue Act of 1978, nullified revenue rulings that any charge account tips actually paid over by the employer to the employee must be reported to the Internal Revenue Service by the employer under section 6041(a) (assuming the aggregate $600 test was met) whether or not the tips were reported to the employer by the employee.[3] Accordingly, the only employee tips which an employer must report to the Internal Revenue Service are those reported to the employer by employees on statements furnished pursuant to section 6053(a).

In enacting section 6041(e), the 1978 Act also provided that, with respect to the amount of tips paid to a particular employee, the only records of charged tips which an employer can be required to keep under section 6001 are charge receipts and copies of statements furnished by employees under section 6053(a). Accordingly, an employer will be required to keep charge receipts (which receipts reflect the amount of tips included by the customer in the charged amount), but may not be required to record on such charge receipts, or otherwise keep records of (except copies of sec. 6053(a) statements), the name of any particular employee to whom the charge tip amount is paid over by the employer.

This recordkeeping limitation relates to records of amounts of such tips paid over to a particular employee and does not affect any other recordkeeping requirements which may be applicable to the employer under section 6001 (e.g., for purposes of determining the employer's own income tax liabilities). Nor does it affect any recordkeeping, reporting, or return requirements imposed on employers pursuant to section 6051 with respect to tips included in statements furnished by employees to the employer pursuant to section 6053(a).

[2] If, because of tip-splitting or tip pooling, the amount of charge tips reported by an employee on his or her Federal income tax return differs from the amount of charge tips reported by the employer for that employee on Form W-2, the rulings permit the employee to attach an explanation of the difference to his or her income tax return.

[3] Section 6041(a) requires every employer of an employee earning $600 or more yearly to report the total of that employee's earnings to the IRS. The regulations specify that any employee's earnings which are not wages subject to withholding are nonetheless required to be reported to the IRS on the Form W-2 for the employee.

### *5. Pensions*

#### *Pensions, IRAs, and annuities*

An information return generally is required with respect to a distribution made to an employee or the employee's beneficiary under a pension, profit-sharing, or stock bonus plan (whether or not tax-qualified), or a tax-sheltered annuity program maintained by an eligible tax-exempt organization or educational institution, if the amount of the distribution which is includible in the recipient's income totals $600 or more for the calendar year (sec. 6041(a)).[4] However, a separate reporting requirement applies to distributions from a tax-qualified plan which benefits an owner-employee (a sole proprietor or a partner whose partnership interest exceeds 10 percent). An information return is required with respect to any owner-employee (or beneficiary of an owner-employee) to whom distributions totaling $10 or more are made during the calendar year, without regard to the amount includible in the recipient's income (sec. 6047).

The trustee or custodian of an individual retirement account or the issuer of an individual retirement annuity (IRA) is required to provide the individual on whose behalf the account or annuity is established (or the individual's beneficiary) an annual report with regard to the status of the account or annuity, including the amount contributed for the year. The report is not now required to be provided to the Internal Revenue Service (sec. 408(i)).[5] Distributions from an IRA are required to be reported by information return to the Internal Revenue Service without regard to the amount of the distribution (sec. 408(i)).

When a United States retirement bond purchased for an employee under a tax-qualified bond purchase plan (sec. 405) is redeemed by the employee or the employee's beneficiary, the Bureau of the Public Debt reports the payment of the redemption proceeds to the Internal Revenue Service. Similarly, when a United States individual retirement bond (sec. 409) is redeemed, the Bureau reports the payment of the redemption proceeds to the Internal Revenue Service.

The issuer of a life insurance or annuity contract not purchased for an employee under a tax-qualified plan or tax-sheltered annuity program generally is required to file an information return with respect to amounts paid to an individual under the contract, if the payments to the individual total $600 or more for the calendar year (sec. 6041(a)). This reporting requirement does not apply, however, to amounts paid by reason of the death of the insured or to amounts paid upon the contract's surrender.

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[4] In the case of a tax-qualified plan, this requirement for an information return applies not only with respect to amounts actually distributed, but also to any amount includible in the income of an employee as an amount paid to provide the employee current life insurance protection (sec. 72(m)(3)). In addition, an employer who provides group-term life insurance for employees is required to separately report any part of the cost of such insurance which is included in an employee's income (sec. 6052). Generally, the cost of the first $50,000 of group-term life insurance provided by an employer is excluded from the employee's income (sec. 79).

[5] The Commissioner may, however, require that the annual report for an IRA be filed with the Internal Revenue Service.

*6. Transactions by brokers*

Under present law (sec. 6045), every person doing business as a broker must, when required by regulation, make a return showing customer's names, together with details regarding the customer's profits and losses and such other information as may be required by form and regulation. Currently, however, there are no regulations promulgated under this section by which the Secretary exercises this authority. The last regulation dealing with broker returns, Regulation 103, § 19.149-1, was revoked by T.D. 5218, February 1, 1943 (1943 C.B. 470), which provided that no return of information was required to be filed under the precurser of section 6045 for any calendar year subsequent to calendar year 1941.

*7. Independent contractors*

In general, individuals receiving compensation must be classified as either employees or independent contractors. The classification of individuals as either employees or independent contractors is important because a certain amount of wages paid to employees is generally subject to (1) social security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and (2) unemployment taxes imposed on the employer under the Federal Unemployment Tax Act (FUTA). In addition, Federal income tax must be withheld from compensation paid to employees while payments to independent contractors are not subject to such withholding. On the other hand, compensation paid to independent contractors is subject to the tax on self-employment income (SECA).

The information reporting and withholding rules applicable to employees are reviewed above. The only information return requirement applicable to independent contractors is that contained in the general information at source section (sec. 6041). Thus, as discussed above, persons engaged in a trade or business must file information returns with respect to certain payments to another person of $600 or more in any taxable year (sec. 6041(a)). This reporting obligation, subject to limited exceptions, applies to payments of commissions, fees, other forms of compensation for services, and other fixed or determinable gains, profits, or income, paid to independent contractors. These information returns must generally contain the name, address and tax identification number of the recipient of the payment.

Further, because there is no Federal income tax withholding with respect to nonwage income, independent contractors may be required to file a declaration of estimated income tax under the rules discussed above.

*8. Currency transactions*

In addition to the information reporting required by the Code, the Bank Secrecy Act authorizes the Secretary of the Treasury to require reporting of certain financial transactions.

Under these rules, certain banks and other financial institutions are required to report cash transactions (including deposits and withdrawals) of more than $10,000. The Treasury regulations provide a number of exceptions to this reporting requirement. Also, persons who bring or send more than $5,000 in cash or other bearer instruments into or out of the United States must report the event to the United States Customs Service. Finally, a United States taxpayer who files a tax return is required to notify the Internal Revenue Service, where provided for on the tax return, of the existence of a foreign bank account or other financial account that he controls or in which he has an interest. If the amount in the account is over $1,000 then the amount must be reported on a separate form to the Treasury Department.

Bank Secrecy Act information is compiled by the Treasury Department, and made available to agents of the Internal Revenue Service.

### *9. Penalties relating to information reporting*

As indicated earlier, the Code requires the filing of a variety of information returns with the Internal Revenue Service. Generally, these returns relate to payments to, and transactions with, other persons. The penalty for failure to file most information returns is $10 per return, subject to a maximum of $25,000 for any calendar year (sec. 6652(a)). The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect.

Also, a person required to file an information return generally must furnish a written statement to the person to whom the payment was made showing certain information. For example, written statements must be furnished to recipients of payments that are reported under section 6041(a) (information at source), section 6042(a)(1) (payment of dividends aggregating $10 or more), and section 6049(a)(1) (payment of interest aggregating $10 or more). Failure to furnish such statements to payees as required subjects the payor to a penalty of $10 for each failure, up to a maximum penalty of $25,000 for any calendar year. This penalty is also not applicable if the payor's failure is due to reasonable cause and not to willful neglect.

Information returns must generally show the name, address and taxpayer identification number (TIN) of the payor and payee. If any person (1) required by regulation to include his TIN in any return, statement, or other document, (2) to furnish his TIN to another person, or (3) to include in any return, statement, or other document made with respect to another person the TIN of such other person, fails to do so at the time prescribed, such person is liable for a penalty of $5 for each failure (sec. 6676). The broad language of this penalty makes it applicable to both the payor and the payee. However, it does not apply if the failure is due to reasonable cause.

Failure to comply with the Bank Secrecy Act reporting requirements can result in severe criminal sanctions. Fines of up to $500,000 and imprisonment for up to five years are provided for long-term patterns of significant violations, and violations in furtherance of certain other Federal crimes. It is also a felony to make a false or fraudulent statement in any of the required reports. Currency and monetary instruments can be seized if they are not reported, or if the report omits material facts. Additional civil penalties are also provided.

## F. Standards for Imposition of Penalties

Under present law, taxpayers may be subject to various additions to tax or civil penalties for failure to comply with filing or payment requirements of the internal revenue laws. With the exception of the addition to tax for failure to pay estimated income tax or for overvaluations, additions and penalities are subject to the taxpayer's defense of "reasonable cause," or the Government is required to prove negligence, fraud, or that the noncompliance was willful.

### *1. Reasonable cause*

The question of whether or not a taxpayer's noncompliance is "due to reasonable cause and not due to willful neglect" depends on the facts and circumstances of each case. For example, for purposes of the addition to tax for failure to file a return or pay tax (sec. 6651), if a taxpayer has an honest belief that he need not file a return or pay an amount of tax, his failure to file or pay may be due to reasonable cause and not willful neglect. On the other hand, ignorance of the law requiring such filing has generally not been viewed by the courts as reasonable cause for failing to comply with filing requirements. Although a taxpayer's uninformed and unsupported belief that he need not file or pay tax is not reasonable cause, a taxpayer's limited education and business experience, together with reliance on the advice of an attorney or certified public accountant, has been held to be reasonable cause for a failure to file a return. See, *Dexter v. U.S.*, 306 F. Supp. 415 (D. Miss. 1970).

Also, a taxpayer's failure to file has been found due to reasonable cause where the taxpayer was mentally incompetent, or where illness prevented the taxpayer from obtaining the necessary records for filing. A taxpayer's incarceration or lack of funds does not, however, constitute reasonable cause.

### *2. Negligence and civil fraud*

If any part of an underpayment of tax is due to "negligence or intentional disregard of rules and regulations (but without intent to defraud)" an addition to tax equal to 5 percent of the entire underpayment may be imposed. In addition, an amount equal to one-half the interest due on the underpayment attributable to negligence will be added to the tax. Similarly, if any part of an underpayment is due to "fraud" an addition to tax equal to 50 percent of the entire underpayment may be imposed.

Whether the taxpayer has been negligent is a question of fact. Ordinarily, the negligence addition to tax will not be imposed where a taxpayer placed complete reliance on his attorney or certified public accountant for filing tax returns and such agent erred on the taxpayer's return. But the taxpayer may be found negligent if he carefully reviewed his return and should have noticed the error, or if he failed to supply his agent with complete information for the return.

Also, if a taxpayer intentionally disregards rules and regulations, he or she may be considered negligent. Likewise the taxpayer's own conviction that the relevant rules or regulations misinterpret the law in a certain instance, if used as a reason for his subsequent disregard thereof, will not necessarily prevent the negligence penalty from being imposed. Generally, the Internal Revenue Service has ruled that where an error is made due to an honest misunderstanding of the facts or the law, the addition for negligence should not be asserted.

In order for the fraud addition to tax to apply it is necessary to show that there was fraudulent intent to evade tax and an underpayment of tax. Mere negligence, or ignorance of the law, does not constitute fraud. Generally, a corporation is responsible for the fraudulent acts of its officers committed on its behalf, and an individual taxpayer cannot escape the penalty for fraud by delegating the preparation of his returns to another. Although, ordinarily, a taxpayer will not be held liable for the fraud addition to tax if he acts upon advice of counsel, he must show that he gave complete and accurate information to his attorney. Finally, a voluntary disclosure after the fact (for example, by the filing of an amended return) will not necessarily relieve a taxpayer of the civil fraud penalty, nor of criminal prosecution therefor (sec. 7203).

### *3. Willful noncompliance*

Willful noncompliance with the internal revenue laws is a fact question. Although "willfulness" is most often associated with criminal penalties, it can also arise in the civil penalty area.

The concept of willfulness is exemplified by its use in the section 6672 penalty for failure to collect, account for, and pay over taxes. The standard of willfulness applied by the courts under that section does not require any bad motive or evil intent on the part of the responsible party. Rather, an intent to do the proscribed act itself is sufficient to render the act "willful." For example, if it is shown that an employer knowingly and intentionally used withheld payroll taxes to pay operating expenses or other debts of the business the act will be deemed willful for purposes of this penalty. Most courts reject the contention that reasonable cause or justifiable excuse plays a part in determining whether the responsible party's actions are willful.

## G. Interest on Underpayments or Overpayments of Tax

### *1. Underpayments*

Under present law (sec. 6601(a)), if a tax is not paid on or before the last date prescribed for payment, interest must be paid by the taxpayer on the unpaid amount for the period of the underpayment at an annual rate established under section 6621.

Under section 6601(b), the last date prescribed for payment is determined without regard to any extension of time for payment and without regard to any notice and demand for payment issued by reason of a jeopardy assessment. If an election to pay the tax in installments is made, the date prescribed for payment of each installment of tax is generally the date from which interest runs. In cases in which the last date for payment is not otherwise prescribed, the last date of payment generally is deemed to be the date the return of tax is due.

### *2. Overpayments*

Under present law (sec. 6611), interest is allowed and paid by the United States on the overpayment of any tax at the annual rate established under section 6621. Under section 6611(b), interest must be allowed and paid with respect to a credit from the date of overpayment (the due date of the return) to the due date of the amount against which the credit is taken; with respect to a refund, it is paid from the date of overpayment to the date (to be determined by the Secretary) preceding the date of the refund check by not more than 30 days. No interest is allowed on an overpayment of income tax if it is refunded within 45 days after the last date prescribed for filing the return of such tax (but without regard to any filing extensions) or, if later, within 45 days after the date the return is filed (sec. 6611(e)).

In addition, there is a special rule for computing interest on an overpayment that results from a carryback of a net operating loss or net capital loss, or from certain credit carrybacks. In general such overpayment is deemed not to have been made prior to the close of the taxable year in which the net operating loss or net capital loss arose.

### *3. Rate of interest*

Both the taxpayer and the United States must pay interest at the annual rate established under section 6621. Under present law if the current rate is at least one full percentage point above or below the average predominant prime rate for September of the current year the rate is adjusted, effective January 1, to be 100 percent of the new prime rate.

### H. Access to a Taxpayer's Books and Records

The Internal Revenue Service has broad, general powers to examine the books and records of taxpayers (sec. 7602). In general, it may do so for the purpose of determining whether a tax return is correct, making a return if none has been made, determining an individual's tax liability, or collecting such tax liability.

Moreover, the Service has the power to compel a taxpayer to produce his books and records by issuing a summons therefor. However, when the taxpayer has records that are within the custody of a third-party recordkeeper, there are special procedures that the Service must follow in order to gain access to those records (sec. 7609). In general, a third-party recordkeeper, for this purpose, is an attorney, an accountant, a bank, a trust company, a credit union, a savings and loan institution, a credit reporting agency, a person who extends credit through the use of credit cards, or a broker in stock or other securities.

If a summons served on a third-party recordkeeper requires the production of records made of the business affairs of any person (other than the third-party recordkeeper) who is identified in the description of the records in the summons, then the Internal Revenue Service must give notice to the person identified in the summons (hereinafter "taxpayer") within 3 days of the day the summons was served, but no later than 14 days before the day the records summoned are to be examined. The notice given to the taxpayer must contain directions for staying compliance with the summons.

The taxpayer may stay compliance with the summons if within 14 days of receiving notice of the summons the third-party recordkeeper is given written notice not to comply with the summons and a copy of that notice is sent by registered or certified mail to the Internal Revenue Service officer specified in the notice given to the taxpayer. (The notice requirements and the right of a taxpayer to stay compliance generally do not apply if a court, after being petitioned by the Service, determines that there is reasonable cause for believing that giving notice might lead to attempts to conceal, destroy, or alter records, to prevent the communication of information from other persons through intimidation, bribery, or collusion, or to flee to avoid prosecution, testifying, or production of records.)

The Internal Revenue Service may not examine any records required to be produced under a summons until after the 14-day period during which the taxpayer may act to stay compliance has expired. If the taxpayer successfully stays compliance by giving the requisite notices, then the Service may not examine the records without a court order or the consent of the taxpayer. In other words, the taxpayer may require the Service to go to court and obtain an order to enforce the summons against the third-party recordkeeper. Present law states that a proceeding brought to enforce a summons takes precedence over all other cases except those the court considers of greater importance.

If compliance with the summons is stayed and the person who stayed compliance is the person whose tax liability is under investigation (or a person under the direction or control of the person whose tax liability is under investigation), then the running of the statutes of limitations for criminal prosecutions and the assessment and collection of tax is suspended while a proceeding to enforce the summons is pending.

# II. IRS ADMINISTRATIVE EFFORTS TO IMPROVE TAXPAYER COMPLIANCE

## A. Taxpayer Services Provided by the Internal Revenue Service

### *1. Programs under the Associate Commissioner (Operations)*

#### *In general*

The IRS conducts a year-round tax information program in each of its 7 regions, 59 internal revenue districts, 10 internal revenue service centers, and in various foreign countries (through the Office of International Operations). The basic assistance part of the program is operated by an Office of Tax Information under the supervision of the Associate Commissioner (Operations) and the Assistant Commissioner (Examinations). Assistance ranges from interpreting technical provisions of the tax law to answering questions on tax account status and furnishing forms requested by taxpayers. In addition, since 1977, the Service has operated a special Problem Resolution Program (discussed below) to handle situations in which normal procedures are considered inadequate.

Taxpayer assistance is provided by three principal methods: telephone assistance, assistance to taxpayers who walk into an Internal Revenue Service office, and taxpayer information and education programs, including programs directed at special groups.

#### *Telephone assistance*

A toll-free telephone network, centralized in 52 answering locations, allows taxpayers to call IRS personnel for tax assistance. This service covers all of the United States, Puerto Rico, and the Virgin Islands. In addition, assistance is provided without cost to deaf and hearing-impaired taxpayers through a television/telephone/teletypewriter system.

#### *Walk-in taxpayer assistance*

The walk-in taxpayer assistance program is available both at permanent and temporary (during the filing season) sites located throughout the country. This is basically a self-help program which includes answering taxpayers' questions and furnishing tax forms and publications. The IRS no longer provides direct return preparation assistance.

#### *Taxpayer information and education*

In addition to its telephone and walk-in assistance programs, the IRS presently conducts a year-round public information program with special emphasis on the filing period (January through April). This program includes training participants in several volunteer programs and supervising the programs, directing educational programs for taxpayers, and preparing media efforts for targeted groups and the general public.

The Volunteer Income Tax Assistance Program (VITA), begun in 1969, provides assistance in completing tax returns to low-income, elderly, and non-English speaking persons who have difficulty obtaining assistance from paid tax return preparers or IRS walk-in assistance personnel. Community volunteers are trained by the IRS in simple tax return preparation skills. These individuals then offer free tax return preparation assistance in neighborhood locations throughout the country.

Tax Counseling for the Elderly, a similar volunteer program, was established by the Revenue Act of 1978, to help meet the special tax needs of persons aged 60 and older. Under this program, the IRS enters into agreements with selected nonprofit organizations which provide volunteers to furnish tax assistance to the elderly. The volunteers are reimbursed by the IRS, through the sponsoring organizations, for out-of-pocket expenses incurred in providing the assistance.

The Student Tax Clinic Program is conducted at 13 colleges and universities across the country. Under this program, law and graduate accounting students represent low-income taxpayers before the IRS in examination and appeal proceedings.

Small Business Workshops and Tax Practitioner Institutes are conducted in each internal revenue district to educate small businessmen and tax practitioners on recent tax developments which may affect them.

Disaster and Emergency Assistance Programs are conducted by IRS in cooperation with other government agencies to provide specialized tax information to victims of major disasters and emergencies.

The Understanding Taxes and Fundamentals of Tax Preparation Programs provide free student publications to high schools and colleges. Additionally, under this program, IRS employees may meet with teachers to explain these publications and answer questions on tax laws and procedures.

### 2. *Problem Resolution Program and Office of the Taxpayer Ombudsman*

In 1977, the Internal Revenue Service implemented a taxpayer complaint response system, known as the Problem Resolution Program (PRP), in each of its districts. Under this program, there is a Problem Resolution Officer in each district who reports directly to the district director. In 1979, this program was expanded to cover all Internal Revenue Service centers, as well as districts.

PRP was established to handle taxpayers' problems and complaints not promptly or properly resolved through normal procedures, or those problems which taxpayers believe have not received appropriate attention. In addition, the program provides for the analysis of problems resolved by it to determine their underlying causes so corrective action can be taken to prevent their recurrence.

In 1979, the IRS established a Taxpayer Ombudsman in the Office of the Commissioner of Internal Revenue. The Ombudsman works under the direct supervision of the Deputy Commissioner of

Internal Revenue. The responsibilities of the Ombudsman include the administration of the Problem Resolution Program; representation of taxpayer interests and concerns within the IRS decision-making process; review of IRS policies and procedures for possible adverse effects on taxpayers; proposal of ideas on tax administration that will benefit taxpayers; and representation of taxpayer views in the design of tax forms and instructions.

In 1981, 318,179 individual taxpayer problems were resolved by the Problem Resolution Program.

## B. Internal Revenue Service Collection and Enforcement Efforts

The major function of the IRS is to collect revenue and enforce the tax laws. The enforcement efforts complement IRS collection efforts both by assisting directly in those collection efforts and by encouraging voluntary compliance with the tax laws.

The following is a summary of the major IRS collection and enforcement efforts in fiscal year 1981.[1]

### 1. Collection efforts

#### Returns received

During 1981, the IRS received and processed 166.5 million returns and supplemental documents. Over 94 million of these (about 56.5 percent) were individual income tax returns.

#### Mathematical correction

During fiscal year 1981, the IRS checked the mathematics on about 91.4 million individual returns. As a result of this, refunds or credits were issued to 3.2 million taxpayers who overstated their tax liabilities by $778 million. Tax liability was understated by $1.2 billion, as a result of math errors, on 3.9 million returns.

With respect to estimated tax payments claimed on individual income tax returns, taxpayers understated those payments by $446 million and overstated about $950 million.

#### Tax receipts

Gross tax receipts in fiscal year 1981 were $606.8 billion. Income taxes accounted for more than two-thirds of this amount. Individual income tax receipts were $332.9 billion and corporation income tax receipts were $73.7 billion.

Social security, self-employment, Federal unemployment, and railroad retirement taxes accounted for $152.9 billion. In addition, excise tax revenue was $40.4 billion. Finally, receipts from estate and gift taxes were $6.9 billion.

#### Refunds

In 1981, the IRS paid $63.3 billion in refunds to 73.6 million taxpayers. Of this amount, $48.4 billion went to filers of Forms 1040 and 1040A.

#### Penalties

During 1981, the IRS accessed $22 million civil penalties, amounting to about $3 billion (about $1 billion in penalties was

[1] The information discussed in this section was derived from the 1981 Annual Report of the Commissioner of Internal Revenue.

abated). These penalties were assessed primarily for failure to pay tax, pay estimated tax, late filing, and negligence and fraud.

*Combined annual wage reporting*

Combined Annual Wage Reporting is a system that is designed to reduce the reporting burden for employers while still satisfying the reporting requirements of both the IRS and the Social Security Administration.

In January 1980, the IRS began a program to ensure that amounts reported on employment tax returns filed with the IRS agree with Forms W-2 filed with the Social Security Administration. This reconciliation is designed to assure that the correct tax has been reported and that employees have received the correct social security coverage. From January 1980, through September 30, 1981, $327.6 million in additional tax has been assessed under this program.

*2. Enforcement efforts*

*Examinations*

In 1981, the IRS implemented a new system for grouping individual income tax returns for examination selection. This new system involves grouping returns by total positive income (TPI) and total gross receipts (TGR).

TPI, which is used for nonbusiness returns, is the sum of all positive income values appearing on a return. Under the previous system of grouping returns by adjusted gross income, losses reduced income items and resulted in the grouping of high-income returns (with tax shelter losses) with low-income returns.

TGR is the sum of business gross receipts and is used to class business returns. Business returns are classed further according to Schedule C (Business or Profession) or Schedule F (Farm). Returns of taxpayers who are predominantly wage earners but have small amounts of business income are classed as nonbusiness returns.

*Examination and correction results*

The IRS examined 1,930,292 returns in 1981. Examination coverage of income, estate, and gift tax returns was 1.84 percent.

The IRS examination program resulted in recommendations for additional tax and penalties of $10.5 billion. Of that amount, individual income tax returns accounted for $2.6 billion, corporate income tax returns for $6.3 billion, fudiciary returns for $38.8 million, estate and gift returns for $1.4 billion, and employment and excise returns for $125 million. This program also disclosed overassessments on 114,994 returns, resulting in refunds of $395 million.

In addition to the IRS examination program, 814,023 returns were verified or corrected through correspondence from IRS service centers, including 668,610 that result from the matching of information documents. This type of examination resulted in recommended additional tax and penalties of $205 million.

*Information returns program*

The Internal Revenue Service received 645 million information documents in its tax year 1980 information returns program. More than 336 million of these documents were submitted on magnetic media. The Internal Revenue Service matches most of the information returns submitted on magnetic media to verify that correct amounts are reported on taxpayers' returns. About 26 percent of the information returns submitted on paper are matched, and 84 percent of the combined magnetic media and paper receipts are matched. In 1981, the Internal Revenue Service began associating information returns with cases of taxpayers who filed income tax returns in previous years but failed to do so for the current year.

As a result of its information returns program, the Internal Revenue Service notified over 1.2 million taxpayers of potential discrepancies between income reported on their tax returns and income reported on information returns. Furthermore, 1.6 million taxpayers were sent notices of apparent failure to file tax returns based on information returns. The information returns program resulted in collection of an additional $500 million for returns processed in 1981.

*Windfall profit tax*

In 1981, the IRS trained more than 700 personnel in oil and gas issues and in windfall profit tax administration. Moreover, 370 employees were trained to handle inquiries about the windfall profit tax. Windfall profit tax liabilities reported on returns processed through September 30, 1981, amounted to about $16.9 billion.

*Large corporations*

The coordinated examination program (CEP) covers financial institutions and utilities whose gross assets exceed $1 billion and other corporations whose gross assets exceed $250 million. CEP is a two-tiered program involving a national CEP and a regional CEP. The most complicated cases are assigned to the national program.

At the end of 1981, there were 942 large corporation cases in the national CEP and 536 cases in the regional CEP. Recommended tax deficiencies and penalties, during 1981, were $4.33 billion.

*Tax shelters*

As of September 30, 1981, there were 248,828 returns with tax shelter issues in the examination process. During 1981, 49,474 returns were closed with recommended tax and penalties of $593.5 million.

In 1981, the IRS established special examination groups for commodity shelters.

*W-4 program (withholding allowance certificates)*

The W-4 program was established in 1980 to check abuses by employees who file incorrect withholding allowance certificates with employers to avoid having high income tax withheld from wages.

During 1981, the IRS expanded the monitoring of employer compliance with the withholding requirements. Furthermore, the IRS is in the process of developing a computer system to detect employers with large payrolls who have not submitted Forms W-4 to the IRS. In addition, a program is being established to follow up automatically on certain W-4 filers who failed to file 1980 income tax returns.

*Unreported income program*

IRS unreported income programs resulted in the identification of more than 24,000 returns. Examination of these returns reflected a noncompliance rate of 83 percent.

The IRS currently is working to develop the capability to identify potential unreported income on filed returns through its discriminant function (DIF) scoring system.

*International enforcement*

Examinations of business operations outside the U.S. are handled by approximately 235 international examiners located in 13 key districts. In 1981, these examiners participated in the examination of 2,900 returns and recommended adjustments and penalties of $2.8 billion.

The Office of International Operations (OIO) has jurisdiction to audit foreign persons with U.S. income. It has foreign posts located in 16 key cities around the world. These foreign posts are headed by revenue service representatives who manage the examination, collection, and taxpayer service programs at those posts. In addition, OIO and its overseas representatives are responsible for the exchange of information with U.S. treaty partners, and for other overseas tax information gathering. In 1981, OIO examined over 18,500 returns and recommended additional tax and penalty assessments of about $950 million.

*Criminal investigation*

The general enforcement program of the Criminal Investigation Division of the IRS (CID) identifies income tax evasion cases with prosecution potential. The program also attempts to provide balanced criminal tax enforcement and geographical and occupational coverage of various types of alleged tax law violations. During 1981, priority enforcement efforts included investigating individuals who filed multiple claims for tax refunds, illegal tax protesters, and promoters of fraudulent tax shelters.

The special enforcement program of the CID identifies and investigates individuals who derive substantial income from illegal activities and violate the tax laws. The program also includes such projects as the Federal strike force program against organized crime, the high-level drug dealers project, wagering tax enforcement, and other efforts against racketeers.

*Cooperation with other agencies*

The IRS is involved in the Federal strike force program against organized crime. The Department of Justice coordinates investigations in 15 strike forces located in 25 cities. The CID also participates in financial investigative task forces established by U.S. attorneys to coordinate the various Federal law enforcement agencies' efforts against major narcotics organizations. Furthermore, IRS special agents are detailed to the Drug Enforcement Administration to identify narcotics traffickers subject to the internal revenue laws.

*Narcotics traffickers*

Since 1980, the IRS has more than doubled the number of staff years involved in investigations of high-level drug traffickers, financiers, and money launderers in its special enforcement program.

*Illegal tax protestors*

In early 1979, the IRS established a comprehensive program to identify illegal tax protestor schemes and to take appropriate action through examination, criminal investigation, and collection programs to assure compliance with the tax laws. As of June 30, 1981, 13,600 illegal tax protestor returns were under examination.

*Collection of delinquent accounts*

During 1981, the IRS disposed of 2.2 million delinquent accounts and collected $5.9 billion in overdue taxes. Of that amount, $2.2 billion was collected in response to computer notices sent to taxpayers and $3.4 billion was collected on delinquent accounts. In addition, overdue taxes of $285 million were collected when 1.5 million delinquent returns, involving $1.8 billion in additional assessments, were secured.

IRS service center collection branches handle computer delinquency notices. This is the first step in communication with taxpayers who have not filed returns or paid taxes. In addition, the service centers perform such procedures as associating taxpayer correspondence, screening cases to determine that a final notice has been sent, and verifying taxpayers' employment.

If taxpayers do not resolve delinquent accounts or delinquent return investigations in response to notices from service centers, their cases are transferred to district offices. Most of these transferred cases are worked first by clerical and paraprofessional employees in the collection office function. However, the more difficult delinquent accounts and return investigations are referred to the collection field function to be handled by revenue officers.

*Nonfilers and delinquent returns*

The Internal Revenue Service has special programs to deal with the problems of nonfilers and delinquent return filers. New procedures for early identification and contact of income tax nonfilers were established in 1980 and further refined in 1981. In addition, in 1981, changes were made in the delinquent returns programs to place greater emphasis on matching information documents and tax returns.

## III. BACKGROUND ON TAX NONCOMPLIANCE

### *Estimated amounts of unreported income*

During the 1970's, a number of analysts of the Federal individual income tax system concluded that substantial amounts of individual income were not reported on individual income tax returns. The estimates of the unreported amounts of income, usually attributed to the underground economy, have varied substantially, and the methods used in making the estimates also have differed.

Peter M. Gutmann, in estimating what he called "the subterranean economy," from which no income is reported for tax purposes, has developed estimates of currency in circulation held by banks and outside of banks, demand deposits and gross national product (GNP). By establishing a ratio of currency to demand deposits in an historic period (1937-1941), which preceded the onset of World War II higher taxes, rationing and price controls, he determined the amount of money needed for legal monetary transactions at any given level of GNP. This ratio then was applied to 1976 data for currency, demand deposits, and GNP, and the resulting estimates applied to 1976 and 1978 GNP and money supply data yielded an estimate of the subterranean economy of about 10 percent of GNP—$176 billion in 1976 and $200 billion in 1978.

Other assertions of the existence of the underground economy often are based on anecdotal information that include references to self- employed individuals in all kinds of activities (including merchants who travel from one flea market to another each weekend) who do not report income, unreported interest and dividend receipts, rents, royalties, capital gains, lottery winnings, and prizes and awards. Such informal information indicates the presence of an underground economy of unreported income, but it provides no guide to the magnitude of the problem.

The Internal Revenue Service reported in 1979 (Publication 1104 (9-79)) on its study of the underground economy in which it estimated separately the amount of income earned in each of the major income sources and further estimated the details for particular subcategories of income by independent contractors, self-employed business people, tip income, etc. The estimates were compared with the amounts reported on income tax returns, with the difference being the unreported amount. These estimates indicated that in 1976 individuals failed to report about $13 to $17 billion of income tax due on about $75 to $100 billion of unreported income from legal sources. These amounts were about 7 percent of $1.073 trillion of income reported from legal sources and about 9 percent of tax due. In addition, the report also estimated that $6 to $9 billion in taxes were not paid on $25 to $35 billion of unreported individual income from criminal activities in narcotics, illegal gambling and prostitution.

These estimates amount to a range of $100 to $135 billion of total unreported income (from legal and illegal sources) for 1976. Given the difficulty of making accurate estimates of unreported income, the difference is quite small between Professor Gutmann's estimate of $176 billion in 1976 and $135 billion as the top of the range estimated by the Internal Revenue Service for the same year.

The Internal Revenue Service unreported income study did not focus on foreign income and the use of foreign secrecy jurisdictions to evade U.S. taxes. The significant problems raised by these types of transactions have been addressed in hearings before the House Ways and Means Oversight Subcommittee (April 24 and 25, 1979), and by a 1981 IRS study on tax havens. No reliable estimates of their impact on U.S. revenues have been made, however.

*Unreported income from legal sources, 1976*

Table 1 lists several types of income that have been underreported by taxpayers. In general, the unreported total was less than 10 percent of the amount of legal income reportable in 1976.

TABLE 1.—ESTIMATED AMOUNT OF UNREPORTED INCOME FOR 1976 AS PERCENT OF REPORTABLE AMOUNT, BY TYPE OF INCOME

[Dollar Amounts in Billions]

| Type of income | Amount of income [1] | | | |
|---|---|---|---|---|
| | Reportable on tax returns | | Reported on tax returns | |
| | From | To | Total [2] | As a percent of amount reportable [1] |
| Legal-source incomes: | | | | |
| Self-employment [3] | $93 | $99 | $60 | 60–64 |
| Wages and salaries | 902 | 908 | 881 | 97–98 |
| Interest | 54 | 58 | 49 | 84–90 |
| Dividends [4] | 27 | 30 | 25 | 84–92 |
| Rents and royalties | 9 | 12 | 6 | 50–65 |
| Pensions, annuities, estates, and trusts | 31 | 33 | 27 | 84–88 |
| Capital gains | 22 | 24 | 19 | 78–83 |
| Other [5] | 9 | 10 | 7 | 70–75 |
| Total | 1,148 | 1,172 | 1,073 | 92–94 |

[1] Sum of components may not add to totals due to rounding. Percents of amounts reportable were computed from unrounded figures.

[2] A small amount of illegal-source incomes are included in the figures below. These inclusions will not significantly affect the percentages shown in the right-hand column.

[3] Self-employment income covers net earnings of farm and nonfarm proprietorships and partnerships (at times referred to as unincorporated business income) as well as net earnings of self-employed individuals working outside the context of regularly established businesses in the legal sector.

[4] Dividends include an estimated portion of distributed net profits of qualified small business corporations.

[5] Includes alimony, lottery winnings, prizes and awards and other types of income.

The unreported income in each of the eight listed categories shows different percentages of compliance.

The highest degree of compliance, 97–98 percent, was in wages and salaries, which also is the predominant source of income—

about 78 percent of reportable income. Wage and salary income is subject to the withholding tax, and W-2 information returns are filed each January with the IRS with respect to the preceding year's income. Sufficient copies of the W-2 returns are distributed to the taxpayers for filing with Federal and State returns and for retention in the taxpayer's records.

Self-employment income is the next largest income category, about $96 billion or 8 percent of total reportable income. The study estimated that only about 60 percent of this income was reported on income tax returns. Unlike wage and salary income, for which a person other than the taxpayer is the payor who withholds some tax each pay period and is responsible for filing W-2 information returns, the self-employed person often operates alone, maintains few or no records, and has nobody withholding or filing a W-2 for him.

Unreported wages and salaries and self-employment income have some common characteristics that make estimating the total amounts difficult and seriously restrict the ability of IRS to attribute the unreported amounts accurately to an individual taxpayer. A substantial portion—as much as two-thirds—of the unreported income is believed to be due to cash transactions. Another major explanation involves informal business activities which include substantial amounts of off-the-record transactions, whether or not payments have been made in cash. The participants in the informal activities may be full- or part-time workers or moonlighters.

Interest or dividend income is reported to the IRS and the taxpayer by the payor or his disbursing agent. The sum of these two sources of income is greater than the amount of self-employment income, but the reporting by the payor on Form 1099 has helped to achieve an 87 percent compliance rate. About the same level of compliance also characterized income from pensions, annuities, estates and trusts.

The estimates indicate the lowest compliance rate (50–65 percent) for reportable income was in the rent and royalty area.

*Unreported income from illegal sources, 1976*

Separate estimates were made by the IRS of the unreported net income from gambling, illegal drugs and prostitution. Illegal gambling, consisting of the numbers racket, bookmaking and other assorted forms of gambling, produced between $8.0 to $10.0 billion in unreported income. Illegal drug traffic unreported income, estimated at $19.9 billion which is the midpoint of the range from $16.2 to $23.6 billion, was derived from traffic in heroin, cocaine, marijuana, and a residual category that included hashish and psychotropic drugs and others. Prostitution unreported income was estimated at $1.1 to $1.6 billion; these estimates were based on police arrest records of streetwalkers and information collected by police of the volume of callgirl business. No estimates were made of the unreported income from other illegal sources, because there is too much uncertainty about the size of total incomes generated by such crimes as loansharking, welfare fraud, bribery, illegal kickbacks, and various other forms of larceny and white-collar crime.

*GAO study of nonfilers*

The General Accounting Office released a study in 1979 in which it discussed the efforts by IRS to detect and pursue individuals who failed to file Federal individual income tax returns in 1972. This study differed from the IRS study, discussed above, in that it concentrated on the types of individuals do not file returns. The IRS study focused on the amounts and kinds of unreported income, and did not distinguish between income that was underreported or omitted on a filed return or income that was unreported because no return was filed.

On the other hand, GAO tried to identify the nonfilers, constructed a profile of individuals who most probably would be nonfilers and recommended procedures for IRS to use in reducing the number of nonfilers.

GAO recommended that Congress consider alternative ways to amend section 6651(a) to impose a late filing charge on nonfilers, identified by the IRS, who subsequently file returns resulting in refunds. It also was recommended that Congress request the IRS to develop and provide the appropriate committees with information on the amount of additional funds needed to improve the effectiveness of IRS nonfiler compliance efforts. The information should include estimates of the costs for (1) estimating and analyzing the nonfiler population, (2) developing a better nonfiler case selection method, and (3) investigating all nonfilers selected.

For 1972 income tax returns, GAO estimated that between 4.1 and 5.3 million individual and joint returns were not filed by those who should have filed. The taxable income of the nonfilers was estimated between $26 and $35 billion, and they had a tax liability between $1.3 and $2.4 billion. The tax liability estimate was not adjusted for income tax withholding that could have reduced the estimate of lost tax receipts. Withholdings of nonfilers were estimated at $500 million by GAO and about $1 billion by IRS.

Using the Exact Match File (see the section that follows), GAO developed a socio-economic profile of nonfilers who had the following characteristics:

(1) About 26 percent of the nonfilers had 8 or fewer years of schooling; 15 percent of the 63 million filers had the same level of schooling. Nonfiling decreased as education levels increased. GAO believed that individuals with low levels of education may find tax laws too complicated and may not be aware of their filing responsibilities.

(2) About 52 percent of nonfilers had incomes of $5,000 or less in contrast with 19 percent of filers in this income range. Individuals with higher incomes are more likely to be filers. GAO suggested that low income nonfilers may not have realized that their incomes exceeded the filing threshold.

(3) Laborers and workers made up about 33 percent of the nonfiler population, but 18 percent of the population of filers. Of the laborers and service workers required to file returns, 13 percent were nonfilers. About 33 percent of all farm laborers and 64 percent of all private household workers were nonfilers.

(4) Self-employed individuals made up 17 percent of the nonfiler population and 9 percent of the filer population. Of the

self-employed individuals, 15 percent did not file even though required to file.

***Preliminary estimates resulting from recent studies***

Preliminary data for 1981 developed in a study which has not yet been published by the Internal Revenue Service indicates that the revenue loss resulting from noncompliance by individuals may be $72 billion in 1981 and $77 billion in 1982. This study projects a compliance gap of $102 billion in 1985 absent any change in the tax laws or the current level of enforcement funding. The preliminary data shows underpayments of $72 billion by individuals (including $8 billion attributable to criminal activities) and $4 billion by corporations.

Of the $64 billion estimated underpayment by individuals engaged in legal activities, $47 billion results from underreporting of income, $12 billion from overstatement of deductions, credits and exemptions, and $5 billion from failures to file tax returns.

Compliance rates by selected income source according to IRS preliminary estimates are shown in Table 2.

TABLE 2.—IRS ESTIMATES OF TAX COMPLIANCE RATES, SELECTED INCOME SOURCES, 1981 (PRELIMINARY)

[In percent]

| Source | | Source | |
|---|---|---|---|
| Wages | 99 | Pensions | 80 |
| Farm business | 92 | Nonfarm business | 80 |
| Interest | 89 | Capital gains | 56 |
| Dividends | 85 | Tip income | 16 |
| State tax refunds | 81 | Illegal income | 5 |

***Estimation methods***

The Internal Revenue Service used several sources to make estimates of underreported income, overstated expenses and the associated tax gap. The primary source of misreporting on returns filed was the Service's Taxpayer Compliance Measurement Program (TCMP). TCMP data are derived from a randomly selected national probability sample of individual returns filed. The weighted results of this sample provide estimates of underreported income by source and overstated deductions, exemptions, and credits discoverable by a reasonable examination. However, not all unreported income is ascertainable upon examination. As a result, IRS conducted a special TCMP-IRP study to determine how much unreported income covered by information reporting was not discovered by TCMP. The results of this special study were used to develop a factor to apply to the TCMP results to estimate total unreported income on individual returns filed.

Major outside sources of data on nonfiler incomes were two Exact Match Files relating to tax years 1972 and 1977. These files were constructed from studies representing joint efforts by the Census Bureau, the Social Security Administration (SSA) and the

Internal Revenue Service. They link information obtained from national household surveys with data from administrative records in SSA and IRS files. The Exact Match Files generated serve as data bases of public record to be used for general statistical research.

Income data from the national income and product accounts (NIPA) were also used, albeit with considerable modifications, mainly as checks of results obtained from the more direct IRS estimation methods. Subtracting estimates of income reported on individual tax returns from comparable NIPA estimates of income paid involves complex, roundabout estimation procedures. Moreover, the NIPA concepts of income differ in some instances from concepts relevant for tax purposes. Even so, the Internal Revenue Service was able to make some use of national income data, particularly in the areas of interest and dividends.

## IV. POSSIBLE APPROACHES TO IMPROVING COMPLIANCE

The precise reasons for the decline in voluntary compliance cannot be easily identified; however, a number of factors may contribute to the problem. For example, the complexity of the tax code and frequent changes in its provisions may contribute to higher levels of taxpayer misunderstanding than existed in earlier times. This higher level of misunderstanding would lead to an increase in inadvertent noncompliance. Noncompliance may be due to inadequacies in the information reporting and withholding systems. If a taxpayer is not informed of items which should be included on his tax return or if incorrect amounts are reported, both the Internal Revenue Service and the taxpayer may have difficulty determining the proper treatment of that item. In addition, the Internal Revenue Service is less able to detect noncompliance in the case of an inaccurately reported item. If the penalties provided under present law are insubstantial in amount or uncertain in their application, taxpayers may consider the cost of noncompliance as relatively low. Similarly, the number of times the Internal Revenue Service contacts taxpayers and the number of returns selected for audit may directly affect the public perception of the risks associated with noncompliance. The growth in international business, and the increased sophistication of taxpayers also opens new opportunities for noncompliance. A number of approaches could lead to increased voluntary compliance either through better understanding of the internal revenue laws or through increasing the risks associated with noncompliance.

### *Education*

To comply with the internal revenue laws, taxpayers must have a general awareness of the requirements imposed on them and an ability to obtain accurate information when they seek to comply with these requirements. For example, many believe that the frequent failure of taxpayers to pay estimated tax is the result of a relatively low level of awareness with respect to the estimated tax payment requirements. Similarly, a significant number of the individuals who fail to file the required income tax returns are subject to wage withholding and may incorrectly believe that payment of tax through the withholding system relieves them of the obligation to file an annual return. It has been suggested that the relatively low level of compliance with respect to pension payments may result from the belief by many taxpayers that retirement income is not subject to Federal income taxation. A broad-based program of public education or an increase in the Internal Revenue Service's taxpayer assistance program might have a positive effect in reducing noncompliance in these and similar areas. There are, however, no data which suggest whether such an educational program would be more or less effective in reducing noncompliance than greater information reporting requirements, broader withholding requirements, or increased sanctions for failure to comply.

*Simplification*

The complexity of the tax laws and the frequency with which they are modified may adversely affect the ability and willingness of taxpayers to comply with the requirements of those laws. For example, a taxpayer who believes that the required returns cannot be understood or filed properly may be less likely to file a return than one who fully understands the requirements. Similarly, because of the law's complexity a taxpayer may have the impression that the law does not equitably distribute the tax burden, which may contribute to a reduction in the voluntary self-assessment. In addition, complexity may place added burdens on the Internal Revenue Service and reduce the likelihood that any particular item will be examined. Thus, proponents of tax simplification argue that greater compliance can be achieved by reducing the complexity of the tax laws. On the other hand, such simplification may entail substantive tax changes which may not be perceived by many as desirable.

*Information reporting*

The information reporting requirements of the Code are intended to serve two purposes. First, they remind taxpayers of their obligation to report amounts on their tax returns and provide them with the information needed to report the amounts. Second, they provide the Internal Revenue Service with the information necessary to detect noncompliance. The information reporting system can fail to accomplish these results in several circumstances. For example, if information returns are not filed or are filed in an incomplete or unprocessable form, their value in detecting noncompliance is lost. In addition, if information reports are available on only some of the elements of a taxpayer's income, then the Internal Revenue Service may not be able to detect noncompliance since its information will be incomplete. Thus, if a taxpayer has income of $10,000 but processable reports are filed on only $5,000, the Internal Revenue Service will not readily detect any underreporting while processing the return as long as at least $5,000 is reported.

The quality of information reporting can be improved by requiring more returns to be in machine processable form, by increasing the penalties for failure to report or failure to provide accurate and complete reports, and by expanding the number of transactions subject to such reporting. Internal Revenue Service data also indicates that information transmitted in connection with withheld taxes has a significantly lower error rate than information on purely informational returns. Simplifying returns, where appropriate, could also increase the quality of information reporting.

Detection of noncompliance can also be improved through strengthening the ability of the Internal Revenue Service to obtain relevant information from third parties. For example, tax treaties could provide for information exchanges between taxing authorities or to permit U.S. access to records held by third parties overseas. In addition, the ability of the Internal Revenue Service to gain access to records held by third parites could be improved by placing restrictions on the ability of taxpayers and third parties to delay response to summonses.

*Withholding*

The most recent Internal Revenue Service compliance data indicates that 99 percent of all wages subject to withholding are reported on tax returns. This high compliance rate is generally attributed to the fact that tax is withheld before the taxpayer receives payments, to the high degree of accuracy in information reported with respect to withheld amounts, and to the ability of the Internal Revenue Service to detect noncompliance effectively. In addition, persons entitled to credits or refunds arising from wage withholding have a strong incentive to file returns and claim those credits or refunds. Although withholding appears to result in higher compliance rates, some people may question whether withholding requirements should be expanded, without further attempting to improve the information reporting system.

*Increased Internal Revenue Service enforcement efforts*

The ultimate deterrents to noncompliance are Internal Revenue Service enforcement efforts and the penalties imposed on taxpayers who fail to comply. Thus, an increase in compliance could be expected from increased spending on Internal Revenue Service enforcement activities, including increased audits of tax returns, and from increased penalties. On the other hand, reliance solely on this approach to increase compliance could reduce voluntary compliance if taxpayers were to develop a strongly negative attitude toward the Internal Revenue Service as a result of increased intrusions by the Internal Revenue Service into their lives.

# V. SECTION-BY-SECTION DESCRIPTION OF S. 2198[1]

## (TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1980)

### Overview

The "Taxpayer Compliance Improvement Act of 1982" is intended to reduce taxpayer noncompliance through a series of provisions designed to encourage complete and accurate reporting of income and deductions. The bill includes provisions improving information reporting, increasing penalties for noncompliance, amending the methods under which interest is computed and substantially revising the withholding rules for pension distributions. Under the bill interest on bearer obligations and obligations of the United States, charged tips, transactions involving securities and commodities, and State and local income tax refunds would be subjected to new reporting requirements. The bill's penalty provisions include a minimum penalty for extended failure to file returns; a substantial increase in the penalty for failure to supply taxpayer identification numbers or to file information returns, and withholding in cases of continuing violations; a 10-percent penalty for any substantial underpayment of tax when the items giving rise to the underpayment were not disclosed on the return; and a penalty on corporate officers and agents, including attorneys and certified public accountants, who commit fraud with respect to a corporation's tax. The interest proposals include provisions for adjusting the interest rate payable by or to the Treasury, and compounding such interest, semiannually. Where applicable, these provisions would cover foreign as well as U.S. transactions.

### Title I—Administrative Provisions

#### *Subtitle A—Reporting Requirements*

#### *Section 101(a)—Interest on bearer instruments and obligations of the United States*

Under present law, the definition of interest subject to information reporting permits the Secretary to provide that interest includes interest on bearer evidences of indebtedness issued by a corporation of a type offered to the public. The Secretary has not exercised this authority. Further, interest as presently defined in the statute, does not include interest on obligations of the United States or its agencies or instrumentalities. There is, therefore, no requirement under the Internal Revenue Code for reporting of interest on bearer obligations or obligations of the United States.

The bill would expand the information reporting requirements of present law to require reporting of interest (including discount on

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[1] Sponsored by Senators Dole, Grassley, Chafee, Domenici, Danforth, Stafford and Andrews.

original issue) on all corporate obligations, including bearer obligations, and interest (including discount on original issue) on obligations of the United States and its agencies and instrumentalities. The mechanics of such reporting would be prescribed under regulations. These new reporting requirements would apply to interest payments reportable on returns, the due date for filing of which is after December 31, 1982. Thus, interest paid in 1982 would be subject to the new reporting requirement.

### *Section 101(b)—Information returns of brokers*

Present law requires that every person doing business as a broker make a return, when required under regulations issued by the Secretary, showing customer names, profits and losses, and such other information as the Secretary may require. There are, currently, no regulations issued under this section.

The bill would direct the Secretary to issue regulations with respect to commodities and securities brokers under the provisions of present law. It would be contemplated that the broker would be required to report only such information as would normally be acquired by the broker in the conduct of its business. Thus, if the broker had all information necessary to compute gain and loss, it would be required to include such information. Absent such information the broker would be required only to report the proceeds of sale. These new regulations would also require reporting on the sale or transfer before maturity of any bond or other evidence of indebtedness other than any sale or transfer by a corporation of any Treasury obligation or any corporate bond or evidence of indebtedness the issuance of which is not required to be registered with the Securities and Exchange Commission, having a maturity of not more than one year. Short-term obligations held by individuals would be subject to such reporting.

These regulations would be issued within six months of enactment of the bill. The first returns under these new regulations would relate to transactions occurring in 1983.

### *Section 102—Information reporting on State and local income tax refunds*

Refunds of State or local income taxes that were deducted in a previous taxable year are includible in a taxpayer's gross income to the extent the deduction gave rise to a tax benefit. Under present law, there is no requirement that information returns for such refunds be filed with the United States or that persons receive information statements on those refunds during the tax filing season.

The bill would require that information returns for State and local tax refunds of $10 or more be filed with the Internal Revenue Service, reporting the amount of any refund payment, credit or offset, the taxpayer's name and taxpayer identification number to the Internal Revenue Service. It would be anticipated that States may satisfy such obligations through voluntary information exchange agreements. A statement with respect to each such return would have to be furnished to the recipient of the refund during January of the year following the year in which the refund is made. This new requirement would apply to refunds, credits, and offsets after December 31, 1982.

*Section 103—Reporting of charged tips*

Under present law, an employee who receives tips in excess of $20, in cash or its equivalent, in the course of his employment must report all such tips in a monthly statement furnished to his employer. The employer must generally take these tips (but no others) into account in determining the amount of tax to be withheld from the employee's wages. No other reporting requirements are imposed on employers with respect to tips.

Under the bill, any employer (other than a small employer) who pays over to an employee $600 or more of charged tips in any taxable year would be required to report those tips to the Internal Revenue Service. Withholding on these charged tips (to the extent not paid over to other employees under pooling arrangements) would be required, as under present law, when the employee reports them together with other tip income to the employer. The amount reported by an employee on his tax return may be different, of course, from that reported by the employer because of pooling and other tip sharing arrangements. Small employers, who are defined as persons who normally have employed five or fewer employees during the previous calendar year, would be exempt from this reporting requirement. The new rules would apply to charge tips paid over to employees after December 31, 1982.

*Section 104—Form of information returns*

In general, returns required by the tax laws must be made according to the forms and regulations prescribed by the Secretary. As a general rule, these returns must be in written form except that in certain cases the return may be made by filing the required information on magnetic tape or other medium, provided that the prior consent to the Commissioner is obtained. There is no statutory or regulatory requirement that any particular sort of return be filed on magnetic tape or in other machine readable form.

The bill would clarify the authority of the Secretary to require that returns be in a form that would permit their prompt and efficient processing, including the filing of multiple returns in machine readable form. These provisions would apply to returns the due date for filing of which is after 1982.

## *Subtitle B—Modification of Interest Provisions*

*Section 111—Interest to be compounded semiannually*

Under present law, interest payable to or by the United States under the tax law is not compounded. Instead, interest is computed on a simple basis.

Under the bill, all interest payable under the Internal Revenue Code would be compounded semiannually. This compounding requirement would apply beginning in 1983 to amounts of interest attributable to periods before 1983 but remaining unpaid, as well as all other interest accruing under the internal revenue laws after 1982.

*Section 112—Semiannual determination of rate of interest*

Under present law, the rate of interest to be paid on underpayments, on overpayments, and for other purposes, must be established by the Treasury no later than October 15 of any year, based on the average predominant prime rate (the rate quoted by commercial banks to their preferred customers for short-term loans), during September of that year, effective January 1 of the following year.

Under the bill, interest rates would be determined semiannually and would be based on the average adjusted prime rate charged by commercial banks during the six-month period ending September 30 (effective January 1 of the succeeding calendar year), and March 31 (effective July 1 of the same calendar year). The amendment would be effective for adjustments taking effect after December 31, 1982.

*Section 113—Restrictions on payment of interest on certain refunds, etc.*

In general, under present law, interest on refunds, credits and offsets runs from the date of overpayment, which is usually the last date prescribed for filing the particular return. Further, under present law, if an overpayment of income tax is refunded within 45 days after the last date prescribed for filing the return, or if later, within 45 days after the date the return is filed, no interest is payable on the overpayment.

Under the bill, no interest would be paid on overpayments shown on late returns for any day before the date on which the return is filed or on refunds made within 45 days after the return is filed. Likewise, an overpayment resulting from a net operating loss carryback, a net capital loss carryback or credit carryback would be deemed not to have occurred prior to the date a claim is filed for such overpayment or credit. Under the bill, for purposes of the payment of interest on overpayments, a return would not be treated as filed until it is filed in processable form. The amendments made by this provision would be applicable to interest paid after enactment except that interest accruing prior to March 11, 1982, would not be affected.

*Subtitle C—Penalty Provisions*

*Section 121—Fraud penalty on corporate directors, officers, employees and agents*

Under present law, a director, officer, employee or agent of a corporation who knowingly participates in fraud with respect to the corporation's tax liability may be subject to a criminal penalty but is not subject to any civil fraud penalty with respect to the corporation's underpayment of tax.

The bill would impose a new civil fraud penalty on corporate directors, officers, employees or agents (including attorneys, accountants, etc.), who knowingly participate in fraud that results in an underpayment of tax by the corporation. Such directors, officers, employees, or agents, would be jointly and severally liable for a penalty equal to 50 percent of the part of the corporate underpayment due to fraud, but the amount that could be collected from any one individual would not exceed $100,000. Participation giving rise to this penalty would include ordering a subordinate to participate in a fraud or condoning the participation of a subordinate in

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fraud. This civil fraud penalty could be asserted at any time before the later of six years after the due date of the corporate return (including extensions) or one year after expiration of any extension of the statute of limitations on assessment of the corporation tax. The new penalty would apply to returns due to be filed after December 31, 1982.

### *Section 122—Minimum penalty for extended failure to file*

Under present law, if a taxpayer fails to file a tax return on the date prescribed (with extensions of time for filing), a penalty is imposed based on the amount of any underpayment of tax for the year. The penalty is 5 percent of the underpayment per month, or fraction thereof, while the failure continues, but not more than 25 percent in the aggregate. Thus, no penalty is imposed on the taxpayer if there is no underpayment for the year or if a refund is due. Likewise, no penalty is imposed if the failure is due to reasonable cause and not due to willful neglect.

The bill would add a new minimum penalty for the extended failure to file any income tax return. If an income tax return is not filed within 60 days of the date prescribed (with extensions), the penalties for failure to file would not be less than $100. Also, this minimum penalty would not be imposed if the failure to file the return was due to reasonable cause. The penalty would apply to returns due after December 31, 1982.

### *Section 123—Criminal penalty for failure to file estimated tax*

Present law imposes a criminal penalty for willful failure to pay any estimated tax at the time required by law. A person convicted of such willful failure is guilty of a misdemeanor and may be fined not more than $10,000 or imprisoned not more than one year (or both), together with costs of prosecution. Such penalty may apply even if no civil penalty can be assessed.

The bill would provide that any person who fails to make any estimated tax payment would not be subject to the criminal penalty for such failure if the civil penalty for failure to pay estimated tax is not applicable.

### *Section 124—Penalty for failure to file information returns or supply identifying numbers*

Present law imposes a penalty on any person who fails to file on the date prescribed (with extensions) information returns including returns relating to certain information at source, payments of dividends aggregating $10 or more, payments of patronage dividends aggregating $10 or more, payments of interest aggegating $10 or more, reporting requirements of certain fishing boat operators, income tax withheld, or payments of wages in the form of group-term life insurance. The penalty is $10 for each such failure, but the total for all such failures during a calendar year can not exceed $25,000. The penalty is not imposed if the failure is due to reasonable cause and not to willful neglect.

Also, present law imposes a penalty of $5 per failure on any person who is required by regulations to include his taxpayer identification number (TIN) in any return, statement or document, to furnish his TIN to another person, or to include in any return or statement made with respect to another person the TIN of such other person, and who fails to comply with such requirement at the time prescribed. The penalty is not imposed if the failure is due to reasonable cause. In practice, this penalty is rarely, if ever, imposed.

The bill would increase the penalty for failure to file the information returns noted above to $50 per failure, the total amount for all such penalties for any calendar year cannot exceed $50,000. The bill would also require a minimum penalty for such failures if the failures are due to intentional disregard of the filing requirements. In such circumstances, the penalty would not be less than 10 percent (5 percent in the case of reports of brokers) of the aggregate amount of the items not properly reported.

In addition, the bill would increase from $5 to $50 per failure (but not to exceed $50,000 in any year) the penalty for a person who fails (1) to include his TIN in a return, (2) to furnish his TIN to another person, or (3) to include, in any return or statement filed or made with respect to another person the TIN of such other person. In the case of the third type of failure, the bill would impose an increased penalty on any filer who intentionally disregarded the requirement to include a payee's TIN on a return. Such filer would be subject to a penalty of $100 per failure, with no limit.

Also, the bill would provide for withholding at source at a tax rate of 15 percent if a taxpayer fails to supply a TIN or supplies an incorrect TIN to another person who must file a return with respect to payments to the taxpayer. If the TIN is not supplied, the payor-filer would start withholding when aggregate payments to the taxpayer for the calendar year exceeded any threshold requiring the reporting of such payments. If the TIN is incorrect, the payor would start withholding upon notice from the Secretary that the taxpayer has failed to supply the correct TIN within 60 days after notice from the Secretary. Such withholding generally would continue as long as the taxpayer failed to supply or correct his TIN.

The penalty provisions would apply after December 31, 1982. The withholding rules would apply only for payments made (or other amounts reported) after December 31, 1983.

***Section 125—Penalty for substantial understatement***

Under present law, a penalty is imposed for failure to pay tax shown on a return or required to be shown on a return, or if any part of any underpayment is due to negligence, certain valuation overstatements, or civil fraud. These penalties either are not imposed if the failure is due to reasonable cause, or require the Service to carry a positive burden of proof. Reasonable reliance on the advice of a tax advisor generally will prevent application of the fraud and negligence penalties.

The bill would add to the Code a new penalty for substantial underpayment of tax arising out of items not disclosed on the taxpayer's return. In the case of an individual, an understatement of tax liability would be substantial only if it exceeds the greater of $5,000 or 10 percent of the amount of tax required to be shown on the return. For corporations, the understatement would be substantial only if it exceeds $10,000 or 10 percent of the tax required to be shown on the return. The new penalty would be 10 percent of that part of any underpayment of tax arising from an undisclosed item. This new penalty may apply to an underpayment in addition to the negligence penalty but would not apply if a fraud penalty or the valuation penalty is imposed. An item would be considered disclosed only if information on the return or an attachment to the return is adequate to apprise the Secretary of the nature and amount of the item. This penalty would apply to returns required to be filed after December 31, 1982.

### *Subtitle D—Withholding on Certain Deferred Income*

#### *Section 131—Withholding on pension payments*

Under present law, income tax generally is not withheld from amounts paid to an employee or beneficiary under a tax-qualified pension, profit-sharing, or stock bonus plan, under a tax-sheltered annuity program, or under an IRA (an individual retirement account or annuity or a U.S. retirement bond). Also, payments under a commercial annuity contract are not generally subject to withholding tax. Tax is required to be withheld, however, if a voluntary withholding request by the recipient is in effect with respect to the annuity.

Under the bill, in the case of a qualified plan, tax may generally be withheld, unless the taxpayer elects otherwise, from taxable benefit payments (typically, annuity payments) as if those payments were wages paid by the plan. In the case of certain total distribution of benefits, however, tax would be withheld under special rules designed to reflect the 10-year forward income averaging and capital gains treatment provided for lump-sum distributions.

In the case of a tax-sheltered annuity program, an IRA, or a commercial annuity contract, the bill would provide that tax would be withheld on taxable payments, unless the taxpayer elects otherwise, as if those payments were wages.

Under the bill, no tax would be withheld from benefit payments (other than total distributions from qualified plans) if the recipient elects not to have the withholding tax apply. Such election may be made for any reason. In the case of a total distribution from a qualified plan, the withholding tax would not apply if the recipient provides notice that the distribution will be rolled over, tax-free, to another qualified plan or to an IRA.

## Title II—Rules and Regulations; Etc.

#### *Section 201—Time for prescribing rules and regulations*

Present law (sec. 7805) provides that the Secretary shall prescribe all needful rules and regulations for the enforcement of the Internal Revenue Code, including rules and regulations necessary due to changes in the tax law. There are no specific time requirements for issuance of such rules and regulations.

Under the bill, the Secretary would be instructed to issue rules and regulations pertaining to amendments to the Code made by the bill and any subsequent Code amendments "as soon as possible." Furthermore, the bill would require the Secretary to report annually to the Congress concerning any delays in issuing regulations required by changes in the Code, the reasons for the delay, and progress made in eliminating such delays.

*Section 202—Paperwork reduction*

Under present law (Paperwork Reduction Act of 1980), information collection requests must be referred to the Office of Management and Budget for approval. The OMB has taken the position that this requirement applies to Treasury Regulations as well as to tax forms.

Under the bill, the Paperwork Reduction Act of 1980 would not apply to any rule or regulation promulgated under the Internal Revenue Code or to any information collection request that the Secretary determines to be authorized by the Code or by any rule or regulation.

*Section 203—Report on forms*

The final provision of the bill would require the Secretary, no later than March 31, 1983, to study and report to the Congress methods of modifying the design of the forms used by the Internal Revenue Service to achieve greater accuracy in the reporting of income and the matching of information reports and returns with the actual income tax returns.

## Revenue Estimates

The revenue estimates for S. 2198 are not yet available.

II

97TH CONGRESS
2D SESSION

# S. 2198

To amend the Internal Revenue Code of 1954 to improve taxpayer compliance, and for other purposes.

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IN THE SENATE OF THE UNITED STATES

MARCH 11 (legislative day, FEBRUARY 22), 1982

Mr. DOLE (for himself, Mr. GRASSLEY, Mr. CHAFEE, Mr. DOMENICI, Mr. DANFORTH, and Mr. STAFFORD) introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To amend the Internal Revenue Code of 1954 to improve taxpayer compliance, and for other purposes.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

**SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.**

(a) SHORT TITLE.—This Act may be cited as the "Taxpayer Compliance Improvement Act of 1982".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

# TITLE I—ADMINISTRATIVE PROVISIONS

## SUBTITLE A—REPORTING REQUIREMENTS

### SEC. 101. TRANSACTIONS INVOLVING CERTAIN OBLIGATIONS.

(a) REPORTING OF INTEREST ON UNITED STATES AND CORPORATE BEARER OBLIGATIONS.—

(1) INTEREST.—Subparagraph (A) of section 6049(b)(1) (defining interest) is amended to read as follows:

"(A) interest on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by the United States or any agency or instrumentality thereof or a corporation;".

(2) ORIGINAL ISSUE DISCOUNT.—Subparagraph (C) of section 6049(a)(1) (relating to requirements of returns) is amended to read as follows:

"(C) which is a corporation (or the United States or any agency or instrumentality thereof) that has outstanding any bond, debenture, note, or certificate or other evidence of indebtedness as to which there is during any calendar year an amount of original issue discount (within the meaning of section 1232(b)) aggregating $10 or more includible in the gross income of any holder,".

(3) CONFORMING AMENDMENT.—Section 6049 is amended by adding at the end thereof the following new subsection:

"(d) SPECIAL RULES RELATING TO UNITED STATES.—

"(1) UNITED STATES TREATED AS PERSON.—For purposes of subsection (a), the term 'person' shall include the United States or any agency or instrumentality thereof.

"(2) PAYMENTS BY THE UNITED STATES.—In the case of payments made by the United States or any agency or instrumentality thereof, officers and employees of the United States or any agency or instrumentality thereof having information with respect to such payments shall, under regulations prescribed by the Secretary, make the returns and statements required by this section.".

(b) RETURNS OF BROKERS.—

(1) REGULATIONS TO BE PRESCRIBED.—Not later than 6 months after the date of the enactment of this Act, the Secretary of the Treasury or his delegate shall prescribe regulations under section 6045 of the Internal Revenue Code of 1954 which require com-

modities and securities brokers to make the returns described in such section with respect to transactions in their capacity as such brokers.

(2) REPORTING WITH RESPECT TO CERTAIN SALES AND TRANSFERS.—In the regulations prescribed in accordance with paragraph (1), the Secretary of the Treasury or his delegate shall require that in any return required to be filed under such regulations there shall be included information with respect to any sale or transfer before maturity of any bond or other evidence of indebtedness other than any sale or transfer by a corporation of any—

(A) Treasury bill with a maturity of not more than 1 year, or

(B) bond or other evidence of indebtedness of a corporation which—

(i) is not required to be registered with the Securities and Exchange Commission, and

(ii) has a maturity of not more than 1 year.

(c) PENALTY FOR FAILURE TO FILE SECTION 6045 RETURNS.—Paragraph (2) of section 6652(a) (relating to returns relating to information at source, etc.) is amended by inserting "required by section 6045 (relating to returns of brokers) or" before "required".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to returns the due date for filing of which (including extensions) is after December 31, 1982.

**SEC. 102. STATE AND LOCAL INCOME TAX REFUNDS.**

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof the following new section:

**"SEC. 6050E. STATE AND LOCAL INCOME TAX REFUNDS.**

"(a) REQUIREMENT OF REPORTING.—Each individual who—

"(1) is charged under the laws of any State or political subdivision thereof with refunding State or local income taxes (within the meaning of section 164(a)(3)); and

"(2) with respect to any person during any calendar year makes payments of, or credits or offsets, refunds of such taxes aggregating $10 or more,

shall make a return according to the forms or regulations prescribed by the Secretary, setting forth the aggregate amount of such payments, credits, or offsets, and the name and address of the person with respect to whom such payment, credit, or offset was made.

"(b) STATEMENTS TO BE FURNISHED TO PERSONS WITH RESPECT TO WHOM INFORMATION IS FURNISHED.—Every person making a return under subsection (a) shall furnish to each person whose name is set forth in such return a written statement showing—

"(1) the name of the State or political subdivision thereof, and

"(2) the aggregate amount of refunds, credits, and offsets to the person shown on the return.

The written statement required under the preceding sentence shall be furnished to the person during January of the calendar year following the calendar year for which the return under subsection (a) was made.".

(b) CONFORMING AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050E. State and local income tax refunds.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to payments of refunds, and credits and offsets made, after December 31, 1982.

**SEC. 103. REPORTING OF CHARGED TIPS.**

(a) IN GENERAL.—Subsection (e) of section 6041 (relating to section not applying to certain tips) is amended to read as follows:

"(e) SECTION DOES NOT APPLY TO CERTAIN TIPS.—

"(1) IN GENERAL.—Except as provided in paragraph (2), this section shall not apply to tips with respect to which section 6053(a) (relating to reporting of tips) applies.

"(2) CHARGED TIPS.—

"(A) IN GENERAL.—In the case of an employer other than a small employer, paragraph (1) shall not apply to charged tips which are paid over by such employer to an employee.

"(B) SMALL EMPLOYER.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'small employer' means with respect to any calendar year an employer who normally employed 5 or fewer employees during the preceding calendar year.

"(ii) AGGREGATION OF EMPLOYEES.—Under regulations prescribed by the Secretary, rules similar to the rules of subsections (a) and (b) of section 52 shall apply.".

(b) CONFORMING AMENDMENT.—The last sentence of section 6001 (relating to notice or regulations requiring records, statements, and special returns) is amended by inserting ", records necessary to comply with section 6041 by reason of section 6041(e)," after "charge receipts".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to tips paid over by an employer to an employee after December 31, 1982.

**SEC. 104. INFORMATION RETURNS.**

(a) METHOD OF REPORTING BY LARGE PAYORS.—Section 6011 (relating to general requirement of return, statement, or list) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) FORM OF REPORTING MUST BE MACHINE PROCESSABLE IN CERTAIN CASES.—The Secretary may by regulations require any person required to file a return under this title to file such return in such form (including magnetic media in the case of any person required to file multiple returns) as the Secretary determines necessary to make such return capable of being processed by such equipment as will be used by the Secretary.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to returns the due date for filing of which (including extensions) is after December 31, 1982.

SUBTITLE B—MODIFICATION OF INTEREST PROVISIONS

**SEC. 111. INTEREST COMPOUNDED SEMIANNUALLY.**

(a) IN GENERAL.—Subchapter C of chapter 67 (relating to determination of rate of interest) is amended by adding at the end thereof the following new section:

"SEC. 6622. INTEREST COMPOUNDED SEMIANNUALLY.

"In computing the amount of any interest required to be paid under this title or section 2411(a) of title 28, United States Code, by the Secretary or by the taxpayer, such interest shall be compounded semiannually.".

(b) CONFORMING AMENDMENTS.—

(1) Section 6601(e) (relating to applicable rules) is amended by striking out paragraph (2) and redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively.

(2) The table of sections for subchapter C of chapter 67 is amended by inserting after section 6621 the following new item:

"Sec. 6622. Interest compounded semiannually.".

(3)(A) The heading for subchapter C of chapter 67 is amended by inserting "; Compounding of Interest" after "Rate".

(B) The item relating to subchapter C in the table of subchapters for chapter 67 is amended by inserting "; compounding of interest" after "rate".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to interest accruing after December 31, 1982.

**SEC. 112. DETERMINATION OF RATE OF INTEREST TO BE MADE SEMIANNUALLY.**

(a) IN GENERAL.—Subsection (b) of section 6621 (relating to determination of rate of interest) is amended to read as follows:

"(b) ADJUSTMENT OF INTEREST RATE.—

"(1) ESTABLISHMENT OF ADJUSTED RATE.—If the adjusted prime rate charged by banks (rounded to the nearest full percent)—

"(A) during the 6-month period ending on September 30 of any calendar year, or

"(B) during the 6-month period ending on March 31 of any calendar year,

is at least 1 percentage point more or less than the interest rate in effect under this section on either such date, respectively, then the Secretary shall establish, within 15 days after the close of the applicable 6-month period, an adjusted rate of interest equal to such adjusted prime rate.

"(2) EFFECTIVE DATE OF ADJUSTMENT.—Any adjusted rate of interest established under paragraph (1) shall become effective—

"(A) on January 1 of the succeeding year in the case of an adjustment attributable to paragraph (1)(A), and

"(B) on July 1 of the same year in the case of an adjustment attributable to paragraph (1)(B).".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to adjustments taking effect after December 31, 1982.

**SEC. 113. RESTRICTIONS ON PAYMENT OF INTEREST FOR CERTAIN PERIODS.**

(a) INTEREST WITH RESPECT TO DELINQUENT RETURNS.—Section 6611(b) (relating to period for which interest on refunds is paid) is amended by adding at the end thereof the following new paragraph:

"(3) LATE RETURNS.—Notwithstanding paragraph (1) or (2), in the case of a return of tax which is filed after the last date prescribed for filing such return (determined with regard to extensions), no interest shall be allowed or paid for any day before the date on which the return is filed.".

(b) NO INTEREST IF RETURN NOT IN PROCESSABLE FORM.—Section 6611 (relating to interest on overpayments) is amended by redesignating subsection (i) as subsection (j) and by adding after subsection (h) the following new subsection:

"(i) NO INTEREST UNTIL RETURN IN PROCESSABLE FORM.—For purposes of subsections (b)(3), (e), and (h), a return shall not be treated as filed until it is filed in such form as may be processed by the Secretary.".

(c) NO INTEREST ON REFUNDS CAUSED BY CERTAIN CARRYBACKS UNTIL CLAIMS FILED BY TAXPAYER.—

(1) NET OPERATING LOSS AND CAPITAL LOSS CARRYBACKS.—Paragraph (1) of section 6611(f) (relating to refund of income tax caused by carryback or adjustment for certain unused deductions) is amended by striking out "prior to the close of the taxable year in which such net operating loss or net capital loss arises" and inserting in lieu thereof "before an application under section 6411 or a claim for credit or refund is filed with respect to such overpayment".

(2) CREDIT CARRYBACKS.—Paragraph (2) of section 6611(f) is amended by striking out "before the close of such subsequent taxable year" and inserting in lieu thereof "before an application under section 6411 or a claim for credit or refund is filed with respect to such overpayment".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by subsections (a) and (b) shall apply to returns filed after the 30th day after the date of the enactment of this Act.

(2) SUBSECTION (a).—The amendments made by subsection (c) shall apply to payments of interest made

after the date of the enactment of this Act with respect to interest accruing after March 11, 1982.

### SUBTITLE C—PENALTY PROVISIONS

### SEC. 121. FRAUD PENALTY ON CORPORATE DIRECTORS, OFFICERS, EMPLOYEES, AND AGENTS.

(a) IN GENERAL.—Section 6653 (relating to failure to pay tax) is amended by inserting after subsection (e) the following new subsection:

"(f) FRAUD PENALTY IMPOSED ON CORPORATE DIRECTORS, OFFICERS, EMPLOYEES, AND AGENTS.—

"(1) IN GENERAL.—If 1 or more directors, officers, employees, or agents of a corporation knowingly participated in any fraud which resulted in a part of any underpayment of tax by such corporation, then there is hereby imposed on all such individuals an aggregate penalty equal to 50 percent of the amount of such part. Except as provided in paragraph (2), each individual described in the preceding sentence shall be jointly and severally liable for any penalty imposed under this paragraph.

"(2) $100,000 LIMITATION PER INDIVIDUAL PER RETURN.—The amount of the penalty imposed under paragraph (1) with respect to any individual with respect to any return shall not exceed $100,000.

"(3) KNOWING PARTICIPATION.—For purposes of this subsection—

"(A) IN GENERAL.—Knowing participation in fraud includes only participation with respect to which such individual knew, or should have known, that such participation would result in an underpayment of tax.

"(B) CERTAIN ACTIVITIES INCLUDED.—Participation in fraud by an individual includes—

"(i) ordering a subordinate (whether or not an officer or employee of the corporation by which the individual is employed) to participate in such fraud, or

"(ii) knowing of, and not attempting to prevent, participation by such a subordinate in such fraud.".

(b) STATUTE OF LIMITATIONS.—Subsection (c) of section 6501 (relating to limitations on assessment and collection) is amended by adding at the end thereof the following new paragraph:

"(8) FRAUDULENT CONDUCT OF CORPORATE DIRECTORS, OFFICERS, EMPLOYEES, AND AGENTS.—In the case of a penalty imposed under section 6653(c), the penalty may be assessed, or a proceeding in court for collection of such penalty may be begun without assessment, before the later of—

"(A) 6 years after the last day prescribed by law (determined with regard to extensions) for filing the return of the corporation to which such penalty relates, or

"(B) in the case of any such return with respect to which an agreement is in effect under paragraph (4), 1 year after the last day on which the tax may be assessed, or a proceeding in court may be begun without assessment, under such agreement.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to returns the due date for filing of which (including extensions) is after December 31, 1982.

**SEC. 122. MINIMUM PENALTY FOR EXTENDED FAILURE TO FILE.**

(a) IN GENERAL.—Subsection (a) of section 6651 (relating to failure to file tax return or to pay tax) is amended by adding at the end thereof the following new sentence: "In the case of a failure to file a return of tax imposed by chapter 1 within 60 days of the date prescribed for filing of such return (determined with regard to any extensions of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, the addition to tax under paragraph (1) shall not be less than $100.".

(b) CONFORMING AMENDMENTS.—Section 6651(c)(1) (relating to additions under more than one paragraph) is amended—

(1) by inserting "(but not below $100 in any case in which the last sentence of subsection (a) applies)" after "reduced" in subparagraph (A), and

(2) by inserting "(determined without regard to the last sentence of such subsection)" after "paragraph (1) of subsection (a)" in subparagraph (B).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to returns the due date for filing of which (including extensions) is after December 31, 1982.

**SEC. 123. RELIEF FROM CRIMINAL PENALTY FOR FAILURE TO FILE ESTIMATED TAX WHERE TAXPAYER FALLS WITHIN STATUTORY EXCEPTIONS.**

Section 7203 (relating to willful failure to file return, supply information, or pay tax) is amended by adding at the end thereof the following new sentence: "In the case of any person with respect to whom there is a failure to pay any estimated tax, this section shall not apply to such person with respect to such failure if, by reason of section 6654(d), there is no addition to tax under section 6654 with respect to such failure.".

SEC. 124. FAILURE TO FILE INFORMATION RETURNS OR SUPPLY IDENTIFYING NUMBERS.

(a) MINIMUM PENALTY FOR FAILURE TO FILE INFORMATION RETURNS.—Subsection (a) of section 6652 (relating to failure to file certain information returns, etc.), as amended by section 101(c), is amended to read as follows:

"(a) RETURNS RELATING TO INFORMATION AT SOURCE, PAYMENTS OF DIVIDENDS, ETC., AND CERTAIN TRANSFERS OF STOCK.—

"(1) IN GENERAL.—In the case of each failure—

"(A) to file a statement of the aggregate amount of payments to another person required by—

"(i) section 6041 (a) or (b) (relating to certain information at source),

"(ii) section 6042(a)(1) (relating to payments of dividends aggregating $10 or more),

"(iii) section 6044(a)(1) (relating to payments of patronage dividends aggregating $10 or more),

"(iv) section 6049(a)(1) (relating to payments of interest aggregating $10 or more),

"(v) section 6050A(a) (relating to reporting requirements of certain fishing boat operators), or "(vi) section 6051(d) (relating to information returns with respect to income tax withheld), or

"(B) to make a return required by section 6045 (relating to returns of brokers) or required by section 6052(a) (relating to reporting payment of wages in the form of group-term life insurance),

on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause, there shall be paid (upon notice and demand by the Secretary and in the same manner as tax), by the person failing to file a statement referred to in subparagraph (A) or failing to make a return referred to in subparagraph (B), $50 for each such failure, but the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $50,000.

"(2) PENALTY IN CASE OF INTENTIONAL DISREGARD.—If 1 or more failures to which paragraph (1) applies are due to intentional disregard of the filing requirement, then with respect to such failures—

"(A) the penalty imposed under paragraph (1) shall not be less than an amount equal to—

"(i) in the case of a return not described in subparagraph (B), 10 percent of the aggregate amount of the items required to be reported, and

"(ii) in the case of a return required to be filed by section 6045, 5 percent of the gross proceeds required to be reported, and

"(B) the $50,000 limitation under paragraph (1) shall not apply.".

(b) INCREASE IN CIVIL PENALTY ON FAILURE TO SUPPLY IDENTIFYING NUMBERS.—Subsection (a) of section 6676 (relating to failure to supply identifying numbers) is amended to read as follows:

"(a) CIVIL PENALTIES.—

"(1) IN GENERAL.—If any person who is required by regulations prescribed under section 6109—

"(A) to include his identifying number in any return, statement, or other document,

"(B) to furnish his identifying number to another person, or

"(C) to include in any return, statement, or other document made with respect to another person the identifying number of such other person,

fails to comply with such requirement at the time prescribed by such regulations, such person shall, unless it is shown that such failure is due to reasonable cause, pay a penalty of $50 for each such failure, except that the total amount imposed on such person for all such failures during any calendar year shall not exceed $50,000.

"(2) PENALTY FOR INTENTIONAL DISREGARD.—If 1 or more failures to which paragraph (1)(C) applies are due to intentional disregard of the inclusion requirement, then paragraph (1) shall be applied with respect to such failures—

"(A) by substituting '$100' for '$50', and

"(B) without regard to the $50,000 limitation.".

(c) WITHHOLDING OF TAX IN CERTAIN CASES.—Section 3402 (relating to withholding at source) is amended by adding at the end thereof the following new subsection:

"(s) EXTENSION OF WITHHOLDING TO CERTAIN INDIVIDUALS WHERE IDENTIFYING NUMBER MISSING OR INCORRECT.—

"(1) IN GENERAL.—If, in the case of a return described in subparagraph (A) (other than clause (vi)) or subparagraph (B) of section 6652(a)(1), a qualified payee with respect to such return—

"(A) fails to provide a required identification number, or

"(B) provides an incorrect required identification number,

then the person required to file such return shall deduct and withhold from the amount of any payment required to be included in such return a tax equal to 15 percent of such amount.

"(2) AMOUNTS AND PERIODS OF WITHHOLDING.—

"(A) FAILURE TO SUPPLY NUMBER.—In the case of a failure described in paragraph (1)(A), the tax under paragraph (1) shall be deducted and withheld on any amount which is paid during any period during which a required identification number has not been provided (or during the 7-day period following such period).

"(B) INCORRECT IDENTIFICATION NUMBER.—In the case of an incorrect required identification number described in paragraph (1)(B), the Secretary shall notify the qualified payee that the qualified payee has 60 days to correct such number. If the qualified payee fails to correct within such 60-day period, the tax under paragraph (1) shall be deducted and withheld on any amount which is paid during the period—

"(i) beginning on the 8th day after the date the Secretary notifies the payor that the payee has an incorrect required identification number, and

"(ii) ending on the 8th day after the date the Secretary notifies the payor that such number has been corrected.

"(C) MINIMUM AMOUNT REQUIRED BEFORE WITHHOLDING.—No amount shall be deducted and withheld with respect to any payment required to be included in any return described in paragraph (1) unless the aggregate amount of such payment and all previous payments during the period for which such return covers exceeds the minimum amount which must be paid before such return is required to be filed.

"(3) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

"(A) QUALIFIED PAYEE.—The term 'qualified payee' means any person with respect to whom a payment is made if such payment is required to be included in any return described in paragraph (1), other than—

"(i) the United States or any agency or instrumentality thereof, "(ii) any State or political subdivision thereof,

"(iii) an organization which is exempt from taxation under section 501(a), or

"(iv) any foreign government or international organization.

"(B) REQUIRED IDENTIFICATION NUMBER.—The term 'required identification number' means an identifying number which is required to be furnished under section 6109.

"(C) PAYMENTS.—The term 'payments' includes amounts other than payments which are required to be included in any return described in paragraph (1).

"(D) AMOUNTS FOR WHICH WITHHOLDING OTHERWISE REQUIRED.—No tax shall be deducted or withheld under this subsection with respect to any amount for which withholding is otherwise required by this title.

"(E) APPLICATION FOR NUMBERS.—The Secretary shall prescribe regulations for exemptions from the tax imposed by paragraph (1) during periods during which a person is waiting for receipt of a required identification number.

"(F) AMOUNTS REQUIRED TO BE INCLUDED IN RETURNS.—The determination as to whether a payment is required to be included in any return described in paragraph (1) shall be made without regard to any minimum amount which must be paid before a return is filed.

"(G) COORDINATION WITH OTHER SECTIONS.—For purposes of this chapter (other than subsection (n)), and so much of subtitle F (other than section 7205) as relates to this chapter, payments of amounts to a qualified payee shall be treated as if they were wages paid by an employer to an employee.".

(d) EFFECTIVE DATES.—

(1) The amendments made by subsections (a) and (b) shall apply to returns the due date for the filing of which (including extensions) is after December 31, 1982.

(2) The amendment made by subsection (c) shall apply to amounts paid after December 31, 1983.

**SEC. 125. PENALTY FOR SUBSTANTIAL UNDERSTATEMENT.**

(a) IN GENERAL.—Subchapter A of chapter 68 (relating to additions to tax and additional amounts) is amended by redesignating section 6660 as section 6661 and by inserting after section 6659 the following new section:

"SEC. 6660. SUBSTANTIAL UNDERSTATEMENT OF LIABILITY.

"(a) Penalty Imposed.—

"(1) In general.—If, in the case of a return of tax imposed by chapter 1 for any taxable year, the underpayment of tax with respect to such return exceeds the greater of—

"(A) $5,000, or

"(B) 10 percent of the amount of tax required to be shown on such return,

then there shall be added to the tax shown on such return an amount equal to 10 percent of such underpayment.

"(2) Corporations.—In the case of a corporation other than an electing small business corporation (as defined in section 1371(b)) or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting '$10,000' for '$5,000'.

"(b) Underpayment Defined.—For purposes of this section—

"(1) In general.—The term 'underpayment' has the same meaning given such term by section 6653(c).

"(2) Reduction for underpayment attributable to disclosed items.—The amount of any underpayment determined under paragraph (1) shall not be greater than the amount which would be determined if the disclosed items had been properly included in the return.

"(3) REDUCTION FOR UNDERPAYMENT DUE TO VALUATION OVERSTATEMENTS.—The amount of any underpayment under paragraph (1) (determined with regard to paragraph (2)) shall be reduced by that portion of the underpayment attributable to a valuation overstatement to which section 6659 applies and which is not a disclosed item.

"(c) DISCLOSED ITEM DEFINED; APPLICATION WITH FRAUD PENALTY.—For purposes of this section—

"(1) DISCLOSED ITEM.—The term 'disclosed item' means any item which is described in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

"(2) APPLICATION WITH FRAUD PENALTY.—If any penalty is assessed under section 6653(b) for an underpayment of tax with respect to a return, no penalty shall be assessed under this section with respect to such underpayment.".

(b) CONFORMING AMENDMENT.—The table of sections for subchapter A of chapter 68 is amended by striking out the last item and inserting in lieu thereof the following:

"Sec. 6660. Substantial understatement of liability.
"Sec. 6661. Applicable rules.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to returns the due date for filing of which (including extensions) is after December 31, 1982.

SUBTITLE D—WITHHOLDING ON DEFERRED INCOME

**SEC. 131. WITHHOLDING ON CERTAIN DEFERRED INCOME.**

(a) IN GENERAL.—Chapter 24 (relating to collection of income tax at source on wages) is amended by adding at the end thereof the following new section:

**"SEC. 3405. SPECIAL RULES FOR CERTAIN DEFERRED INCOME.**

"(a) GENERAL RULE.—For purposes of this chapter (and so much of subtitle F as relates to this chapter), any payment of a qualified distribution to an individual shall be treated as if it were a payment of wages by an employer to an employee.

"(b) ELECTION NOT TO HAVE SECTION APPLY.—

"(1) NONTOTAL DISTRIBUTIONS.—

"(A) IN GENERAL.—An individual may elect with respect to any calendar year not to have the provisions of subsection (a) apply to any portion of any qualified distribution received by such individual from a payor during such calendar year which is not part of a total distribution.

"(B) TIME AND MANNER OF ELECTION.—

"(i) IN GENERAL.—An election under subparagraph (A) shall be made by notifying the payor of such election at such time and in such manner as the Secretary may prescribe by regulations.

"(ii) NOTICE OF RIGHT TO ELECT.—Notice of the right to make an election under this section shall be given to the recipient at such times as the Secretary shall prescribe by regulations.

"(C) PERIOD OF ELECTION REMAINING IN EFFECT.—An election under subparagraph (A) shall take effect at such time as the Secretary may prescribe by regulations and shall remain in effect for the calendar year for which made unless revoked earlier.

"(2) TOTAL DISTRIBUTIONS.—In the case of a qualified distribution which is part of a total distribution, the provisions of subsection (a) shall not apply to that portion of such qualified distribution with respect to which the individual receiving such distribution notifies the payor, in such form and manner as the Secretary may prescribe, that such portion will not be includible in gross income by reason of a qualified rollover.

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"(c) AMOUNT WITHHELD IN THE CASE OF TOTAL DISTRIBUTIONS.—In the case of a qualified distribution which is part of a total distribution—

"(1) IN GENERAL.—Notwithstanding section 3402, the Secretary shall prescribe tables or computational procedures for purposes of computing the amount of tax to be withheld under subsection (a) which are based on the amount of tax which would be imposed on such distribution under section 402(e) if—

"(A) the recipient elected to treat such distribution as a lump-sum distribution (within the meaning of section 402(e)(4)(A)), and

"(B) such distribution were attributable solely to active participation after December 31, 1973.

"(2) SPECIAL RULE FOR DISTRIBUTIONS BY REASONS OF DEATH.—In the case of qualified distributions from or under an eligible retirement plan described in subparagraph (A), (B), or (C) of subsection (g)(3) which are made by reason of a participant's death, the Secretary, in prescribing tables or procedures under paragraph (1), shall take into account the exclusion from gross income provided by section 101(b) (whether or not allowable).

"(d) MAXIMUM AMOUNT WITHHELD.—The maximum amount to be withheld under subsection (a) on any qualified distribution shall not exceed the sum of the amount of money and the fair market value of other property (other than employer securities of the employer corporation (within the meaning of section 402(a)(3)) received in the distribution.

"(e) LIABILITY FOR WITHHOLDING.—

"(1) IN GENERAL.—Except as provided in paragraph (2), the payor of a qualified distribution shall deduct and withhold, and be liable for, payment of the tax required to be deducted and withheld under this section.

"(2) PLAN ADMINISTRATOR LIABLE IN CERTAIN CASES.—In the case of an eligible retirement plan described in subparagraph (A), (B), or (H) of subsection (g)(3), paragraph (1) shall not apply and the plan administrator shall deduct and withhold, and be liable for, payment of the tax unless the plan administrator—

"(A) directs the payor to deduct and withhold such tax, and

"(B) provides the payor with such information as the Secretary may require by regulations.

"(f) ROLLOVERS OF AMOUNTS WITHHELD.—

"(1) IN GENERAL.—If—

"(A) any tax is deducted and withheld under subsection (a) on a qualified distribution which is part of a total distribution, and

"(B) the entire amount of such qualified distribution (other than the amount of such tax) is not includible in gross income by reason of a qualified rollover,

then there shall not be includible in gross income that portion of the amount of such tax with respect to which the recipient, before August 15 of the calendar year following the calendar year in which the distribution was made, takes such actions as are necessary (as determined under regulations prescribed by the Secretary) to have such portion treated as a qualified rollover.

"(2) INCLUSION IN INCOME OF AMOUNTS NOT ROLLED OVER.—If a recipient does not take the actions described in paragraph (1) with respect to any portion of the tax described in such paragraph, the amount of such portion shall be includible in gross income in the taxable year in which the qualified distribution of which it was a part was made.

"(g) DEFINITIONS.—For purposes of this section—

"(1) QUALIFIED DISTRIBUTION.—The term 'qualified distribution' means any distribution or payment—

"(A) from or under an eligible retirement plan or commercial annuity, and

"(B) which is includible in the gross income of the recipient for the taxable year of the recipient in which it is received or any preceding taxable year.

"(2) TOTAL DISTRIBUTION.—

"(A) IN GENERAL.—The term 'total distribution' means the distribution or payment (within 1 taxable year of the recipient) of the balance to the credit of the individual on whose behalf the recipient is entitled to such distribution or payment.

"(B) SPECIAL RULE FOR ACCUMULATED DEDUCTIBLE EMPLOYEE CONTRIBUTIONS.—For purposes of subparagraph (A), accumulated deductible employee contributions (within the meaning of section 72(o)(5)(B)) shall be treated separately in determining if there has been a total distribution.

"(3) ELIGIBLE RETIREMENT PLAN.—The term 'eligible retirement plan' means—

"(A) an employees' trust described in section 401(a) which is exempt from taxation under section 501(a),

"(B) an annuity described in section 403(a),

"(C) an annuity contract described in section 403(b),

"(D) a plan described in section 405(a),

"(E) an individual retirement account described in section 408(a),

"(F) an individual retirement annuity described in section 408(b),

"(G) a retirement bond described in section 409, or

"(H) a plan described in section 301(d) of the Tax Reduction Act of 1975.

For purposes of this paragraph, a trust, plan, account, annuity, or bond shall be treated as described in a subparagraph of this paragraph if it at any time was, or determined by the Secretary to be, described in any such subparagraph.

"(4) COMMERCIAL ANNUITY.—The term 'commercial annuity' means an insurance or annuity contract issued by an insurance company licensed to do business under the laws of any State.

"(5) PLAN ADMINISTRATOR.—The term 'plan administrator' has the meaning given such term by section 414(g).

"(6) QUALIFIED ROLLOVER.—The term 'qualified rollover' means a rollover described in section 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8), 405(d)(3), 408(d)(3), or 409(b)(3).".

(b) FILING OF REPORTS.—

(1) IN GENERAL.—Section 6047 (relating to information concerning certain trusts and annuity and bond purchase plans) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) REPORTS BY EMPLOYEES AND PLAN ADMINISTRATORS.—The Secretary may by regulations require that the employer maintaining, or plan administrator (within the meaning of section 414(g)) of, an eligible retirement plan described in subparagraph (A), (B), (D), or (H) of section 3405(g)(3) make returns and reports regarding such plan to the Secretary, to the participants and beneficiaries of such plan, and to such other persons as the Secretary may prescribe by regulations. Such reports shall be in such form, made at such time, and contain such information as the Secretary may prescribe by regulations.".

(2) SECTION 6041.—Section 6041 (relating to information at source) is amended by adding at the end thereof the following new subsection:

"(f) SECTION NOT TO APPLY TO CERTAIN PAYMENTS.—This section shall not apply to payments which are required to be included in returns and reports under section 6047(e).".

(c) CONFORMING AMENDMENTS.—

(1) Section 31(a)(1) (relating to credit for wage withholding for income tax purposes) is amended by inserting "or 3405" after "3402".

(2)(A) Paragraph (1) of section 3402(o) (relating to extension of withholding to certain payments other than wages) is amended—

(i) by inserting "and" at the end of subparagraph (A),

(ii) by striking out subparagraph (B), and

(iii) by redesignating subparagraph (C) as subparagraph (B).

(B) Paragraph (2) of section 3402(o) is amended—

(i) by striking out subparagraph (B), and

(ii) by redesignating subparagraph (C) as subparagraph (B).

(C) Paragraph (3) of section 3402(o) is amended—

(i) by striking out "an annuity or", and

(ii) by striking out "annuity payments or" in the heading.

(D) Paragraph (4) of section 3402(o) is amended—

(i) by striking out "an annuity or" in the matter which precedes subparagraph (A) thereof; and

(ii) by striking out subparagraph (C) and inserting in lieu thereof the following:

"(C) shall take effect with respect to payments made more than 7 days after the date on which such request is furnished to the payor.".

(3)(A) The table of sections of chapter 24 is amended by adding at the end thereof the following new item:

"Sec. 3405. Special rules for certain deferred income.".

(B) The heading for chapter 24 is amended by inserting "**AND CERTAIN DEFERRED INCOME**" after "**WAGES**".

(d) Effective Date.—The amendments made by this section shall apply to payments made after December 31, 1982.

# TITLE II—RULES AND REGULATIONS; PAPERWORK REDUCTION

**SEC. 201. TIME FOR PRESCRIBING RULES AND REGULATIONS; REPORT.**

(a) REGULATIONS TO BE TIMELY PRESCRIBED.—Section 7805 (relating to rules and regulations) is amended by adding at the end thereof the following new subsection:

"(d) EXPEDITED RULES AND REGULATIONS.—In the case of any rule or regulation required by any amendment of, or addition to, this title made after the date of the enactment of this section, the Secretary shall prescribe such rules and regulations as soon as possible.".

(b) REPORT BY SECRETARY.—The Secretary of the Treasury shall report to the Congress annually with respect to—

(1) any delays in issuing regulations required by changes in the Internal Revenue Code of 1954 and the reasons for such delays, and

(2) any progress made in eliminating such delays.

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to regulations pursuant to amendments of, and additions to, the Internal Revenue Code of 1954 made by this Act or made on or after the date of the enactment of this Act.

**SEC. 202. PAPERWORK REDUCTION.**

(a) IN GENERAL.—Section 7852 (relating to other applicable rules) is amended by adding at the end thereof the following new subsection:

"(f) PAPERWORK REDUCTION.—Chapter 35 of title 44, United States Code, shall not apply to any collection of information requirement contained in any rule or regulation enforcing any provision of this title or to any information collection request which the Secretary determines to be authorized by any provision of this title or any such rule or regulation.".

(b) EFFECTIVE DATE.—The amendment made by subsection (b) shall be effective as of April 1, 1981.

**SEC. 203. REPORT ON FORMS.**

Not later than March 31, 1983, the Secretary of the Treasury or his delegate shall study and report to the Congress methods of modifying the design of the forms used by the Internal Revenue Service to achieve greater accuracy in the reporting of income and the matching of information reports and returns with the returns of tax imposed by chapter 1.

STATEMENT OF SENATOR BOB DOLE
ON
THE TAXPAYER COMPLIANCE IMPROVEMENT ACT
MARCH 22, 1982

I AM PLEASED THAT UNDER THE LEADERSHIP OF SENATOR GRASSLEY, THE ORIGINAL SPONSOR WITH ME OF S. 2198, THE SUBCOMMITTEE ON OVERSIGHT OF THE IRS HAS SCHEDULED A HEARING TODAY ON S. 2198 AND ON THE PROBLEMS OF TAXPAYER COMPLIANCE.

## WHY S. 2198 IS IMPORTANT

THIS IS AN IMPORTANT BILL. IT IS IMPORTANT BECAUSE IT CONSTITUTES THE FIRST COMPREHENSIVE, STRUCTURAL REFORM OF THE VOLUNTARY COMPLIANCE SYSTEM SINCE ENACTMENT OF THE 1954 CODE. S. 2198 IS ALSO IMPORTANT BECAUSE, TOGETHER WITH THE ADMINISTRATION'S ADDITIONAL IRS BUDGET AUTHORITY AND LIMITED ADDITIONAL SPENDING ON IRS DATA PROCESSING AND EXAMINATION FUNCTIONS, IT WILL GENERATE AN ESTIMATED ADDITIONAL $20 BILLION OVER THE NEXT 3 YEARS. THUS, THE BILL CAN BE AN IMPORTANT PART OF OUR DEFICIT REDUCTION PLAN.

## COLLECTING TAXES OWED IS A FIRST STEP

WE IN CONGRESS ARE WRESTLING DAILY WITH WHAT IS AT LEAST A $150 BILLION PROBLEM, THE 1983 FEDERAL DEFICIT. NOT ONLY WILL WE BE ASKED TO CUT IMPORTANT DISCRETIONARY SPENDING PROGRAMS AND ENTITLEMENTS, BUT WE WILL BE ASKED TO RAISE TAXES, INCLUDING THE

TAXES OF PERSONS WHO HAVE PREVIOUSLY PAID THE TAXES THEY OWE. I THINK WE MUST DO BOTH. BUT BEFORE WE DO EITHER, I BELIEVE WE MUST MAKE FURTHER EFFORTS TO COLLECT THE MORE THAN $70 BILLION OF TAXES THAT TODAY GOES UNREPORTED AND UNPAID.

## GOOD TAX ADMINISTRATION IS GOOD GOVERNMENT

I BELIEVE THIS BILL AND ITS PROPOSALS WILL RECEIVE STRONG BIPARTISAN SUPPORT. FAIR AND EFFECTIVE TAX ADMINISTRATION IS NOT A PARTISAN GOAL. CONCERN ON BOTH SIDES OF THE AISLE WITH THE IMPENDING DEFICITS, AS WELL AS WITH THE FAIRNESS OF OUR TAX SYSTEM, INSURES BROAD, BIPARTISAN SUPPORT FOR THIS MEASURE. ON THE OTHER SIDE OF THE HILL, THE DISTINGUISHED RANKING MINORITY MEMBER OF THE HOUSE WAYS AND MEANS COMMITTEE, BARBER CONABLE, HAS INTRODUCED THIS BILL. I UNDERSTAND THAT CHAIRMAN ROSTENKOWSKI, IS ALSO REVIEWING THESE PROBLEMS AND THE OPPORTUNITY FOR LEGISLATIVE ACTION. I HOPE HE WILL BE ABLE TO JOIN US IN THIS EFFORT.

I LOOK FORWARD TO HEARING THE VIEWS OF OUR WITNESSES ON THIS IMPORTANT MEASURE.

OPENING STATEMENT OF SENATOR CHARLES GRASSLEY OF IOWA
MARCH 22, 1982 BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE IRS

I'D LIKE TO CALL THIS HEARING OF THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE TO ORDER. THE TOPIC OF OUR HEARING TODAY IS S. 2198, THE TAXPAYER COMPLIANCE IMPROVEMENT ACT, A MEASURE SPONSORED BY SENATOR DOLE AND ME, AND CO-SPONSORED BY TWO OTHER FINANCE COMMITTEE MEMBERS, SENATORS CHAFEE AND DANFORTH. THIS IS A VERY IMPORTANT STEP IN ACHIEVING EQUITY FOR ALL TAXPAYERS. OUR BILL LOOKS AT THE ENTIRE TAX SYSTEM IN A COMPREHENSIVE WAY IN AN ATTEMPT TO MAXIMIZE COMPLIANCE. THE WORKING MEN AND WOMEN OF AMERICA DON'T MIND PAYING TAXES — THEY JUST WANT EVERYBODY TO PAY THEIR FAIR SHARE.

S. 2198 DOES NOT CREATE NEW TAX LIABILITY; HOWEVER, IT MAKES A THOROUGH ATTEMPT TO COLLECT TAXES FROM THOSE WHO OWE THEM AND HAVE NOT PAID. BOTH SENATOR DOLE AND I FEEL IT WOULD BE TREMENDOUSLY UNFAIR TO BEGIN LOOKING FOR WAYS TO INCREASE TAXES WITHOUT FIRST TRYING TO COLLECT TAXES ALREADY OWED BY THOSE WHO ARE TRYING TO AVOID THEIR LEGAL OBLIGATION TO PAY TAX. THERE IS NO REASON TO INCREASE THE HONEST TAXPAYER'S BILL WITHOUT MAKING A SINCERE ATTEMPT TO COLLECT TAX FROM DISHONEST OR NEGLIGENT TAXPAYERS. I BELIEVE OUR PROPOSALS WILL HAVE BROAD BI-PARTISAN SUPPORT AND PROPERLY SO, SINCE DEMOCRATS AND REPUBLICANS ALIKE ARE CONCERNED WITH THE LEVEL OF PROJECTED DEFICITS AND THE NEED FOR A FAIR TAX SYSTEM.

THIS BILL ALSO HAS THE ADDED BENEFIT OF RAISING MONEY FOR THE TREASURY. ACCORDING TO THE PRELIMINARY ESTIMATES OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION, THIS MEASURE, WHEN COUPLED WITH ADDITIONAL SPENDING FOR IMPROVED COLLECTION, WILL RAISE APPROXIMATELY $3.0 BILLION IN FY 83, $8.1 BILLION IN FY 84, AND $9.3 BILLION IN FY 85. I UNDERSTAND THE STAFF IS CURRENTLY REVIEWING THESE ESTIMATES AND FINAL ESTIMATES WILL BE RELEASED WHEN AVAILABLE.

OUR BILL DOES NOT INCLUDE BROAD-BASED WITHHOLDING AS A COLLECTION TECHNIQUE. RATHER, IT RELIES ON EXTENSIVE INFORMATION REPORTING BY TAXPAYERS OR THIRD PARTY PAYORS TO THE INTERNAL REVENUE SERVICE. WHILE ALL OF THE SPONSORS OF THIS BILL ARE CONCERNED ABOUT THE ADDITIONAL REPORTING BURDEN THIS BILL PLACES ON CERTAIN PERSONS, WE FELT IT WAS A BETTER ALTERNATIVE THAN "WITHHOLDING" TO COLLECT TAXES OWED THE GOVERNMENT.

IN AN EFFORT TO IMPROVE VOLUNTARY COMPLIANCE, WHICH IS SLIPPING, WE HAVE INSTITUTED SOME NEW AND STRONGER PENALTIES FOR THOSE WHO FAIL TO COMPLY WITH THE LAW. WE HAVE CREATED A PENALTY FOR THOSE INDIVIDUALS WHO SUBSTANTIALLY UNDERSTATE THEIR TAX LIABILITY BY AT LEAST $5,000 WITHOUT FLAGGING THE ISSUE LEADING TO THE DEFICIENCY. THIS PROVISION IS SPECIFICALLY DESIGNED TO DISCOURAGE HIGH INCOME TAXPAYERS FROM PLAYING THE AUDIT LOTTERY. IMPROVED PENALTIES ARE NECESSARY TO BE SURE VOLUNTARY COMPLIANCE DOES NOT SLIP FURTHER. VOLUNTARY COMPLIANCE IS THE MAINSTAY OF OUR REVENUE COLLECTION SYSTEM. WITHOUT VOLUNTARY COMPLIANCE, THE GOVERNMENT WOULD NOT BE ABLE TO COLLECT THE TAX DUE WITHOUT SERIOUS INFRINGEMENTS ON EACH INDIVIDUAL'S PRIVACY.

THE ENACTMENT OF S. 2198 WILL ENHANCE TAXPAYER'S PERCEPTION OF THE SYSTEM OF VOLUNTARY COMPLIANCE. THESE CHANGES SET OUT A SYSTEM WHICH IS FUNDAMENTALLY FAIR — IT REQUIRES EACH TAXPAYER TO PAY WHAT HE OR SHE OWES. ALSO, BY COLLECTING THESE OUTSTANDING OBLIGATIONS DUE AND OWING, IT PERMITS THE FEDERAL GOVERNMENT TO REDUCE THE DEFICIT. $20 BILLION OVER THREE YEARS WILL NOT BALANCE THE BUDGET, BUT IT IS A RELATIVELY PAINLESS STEP TOWARD THAT GOAL.

THE SUBCOMMITTEE IS LOOKING FORWARD TO ALL OF THE WITNESSES, BEGINNING WITH THE COMMENTS OF THE ADMINISTRATION WITNESSES, ASSISTANT SECRETARY OF THE TREASURY JOHN CHAPOTON AND COMMISSIONER OF INTERNAL REVENUE ROSCOE EGGER. FIRST, I WOULD LIKE TO ASK SENATOR BAUCUS OR SENATOR DOLE IF THEY HAVE OPENING REMARKS.

Senator GRASSLEY. I would like to call this hearing of the Subcommittee on Oversight of the Internal Revenue Service to order.

The topic of our hearing today is S. 2198, the Taxpayers Compliance Improvement Act of 1982, a measure sponsored by Senator Dole and myself, and cosponsored by two other Finance Committee members, Senator Chafee and Senator Danforth.

This is a very important step in achieving equity for all taxpayer. Our bill looks at the entire tax system in a comprehensive way in an attempt to maximize compliance. The working men and women of America don't mind paying taxes, they just want to make sure that everybody else pays their fair share of taxes as well.

S. 2198 does not create new tax liability; however it makes a thorough attempt to collect taxes from those who owe them and have not paid. Both Senator Dole and I feel it would be tremendously unfair to begin looking for ways to increase taxes without first trying to collect taxes already owed by those who are trying to avoid their legal obligation to pay taxes. There is no reason to increase the honest taxpayer's bill without making a sincere attempt to collect taxes from dishonest or negligent taxpayers.

I believe our proposals will have broad bipartisan support, and properly so, since Democrats and Republicans alike are concerned with the level of projected deficits and the need for a fair tax system.

This bill also has the added benefit of raising money for the Treasury. According to the preliminary estimates of the staff of the Joint Committee on Taxation, this measure when coupled with additional spending for improved collection will raise approximately $3 billion in fiscal year 1983, $8.1 billion in fiscal year 1984, and $9.33 billion in fiscal year 1985. That's about $20 billion for the next 3 fiscal years.

Our bill does not include broad-based withholding as a collection technique; although, that idea has been put forward recently and by past administrations. Rather, our bill relies on extensive information reporting by taxpayers or third-party payors to the Internal Revenue Service. While all of the sponsors of this bill are concerned about the additional reporting and the burden from reporting this bill places on certain persons, we felt it was a better alternative than withholding to collect taxes owed the Government.

In an effort to improve voluntary compliance, which is slipping, we have instituted some new and stronger penalties for those who fail to comply with the law. We have created a penalty for those individuals who substantially understate their tax liability by at least $5,000 without flagging the issue leading to the deficiency. This provision is specifically designed to discourage high-income taxpayers from playing what is referred to as the audit lottery. Improved penalties are necessary to be sure voluntary compliance does not slip further. Voluntary compliance is the mainstay of our revenue collection system. Without voluntary compliance the Government would not be able to collect the taxes due without serious infringements on each individual's privacy.

The enactment of this bill will enhance taxpayers' perception of the system of voluntary compliance. These changes set out a system which is fundamentally fair. It encourages each taxpayer to pay what he or she owes. Also, by collecting these outstanding obligations due and owing it permits the Federal Government to reduce the deficit. Twenty billion dollars over these 3 years will not balance the budget, but it is a relatively painless step toward that goal.

The subcommittee is looking forward to all of the witnesses, beginning with the comments of the administration witnesses: Assistant Secretary of the Treasury, John Chapoton, and Commissioner of Internal Revenue, Roscoe Egger.

First of all, I would like to call on Senator Dole. If Senator Baucus comes yet before we start our questioning, I will call on Senator Dole as the ranking majority member to give any opening remarks that he might have.

Senator Dole.

Senator DOLE. First, I want to commend Senator Grassley for his quick hearings on what I consider to be a very sound proposal. And I would ask that my statement be made a part of the record.

He has underscored the importance of this bill. It is not a gimmick and it is not something we are going to take lightly. It is something that, if in fact we can keep what we have in the legislation, we could pick up an estimated $20 billion over the next 3 years, and that's a lot of money.

But we have got a $150 billion or higher problem in this Congress in fiscal year 1983, and we are looking for revenues as well as spending cuts, entitlement cuts, revenue enhancement, management initiatives, user fees, every conceivable way to pick up enough revenue. And I think, before we spend too much time focusing on some of those areas, we ought to make certain that some people and some businesses are at least paying some tax before we go back to others and ask for another contribution.

So, I suggest this is a very important hearing. It is really the first effort to take a hard look at our self-assesment system since 1954.

I commend Senator Grassley for his leadership, for cosponsoring S. 2198. It is my hope that we can wrap this up fairly quickly and put it on the so-called package—we hope it's a package—that will be added to the debt ceiling that is going to sail through here, I hope not later than May 1. I've moved up the timetable 30 days.

I know there are some who won't like this bill. People just don't like to pay taxes, particularly those who have never tried it. [Laughter.]

It would seem to me that, once you get used to it, it's not so bad. It's like anything else. But we will hear from some who will say, "Oh, you can't do this to waiters," and you can't do this to others. Why can't you do this to people who have an income and don't report it? That's the question.

I would think the great majority of Americans who pay their taxes would be insisting that we do at least this much. And if we don't succeed in this voluntary effort through more information, maybe we will have to go to withholding; because when you withhold taxes, you get about 99 percent compliance. But when you don't withhold taxes, you get down to—well, even capital gains, you only get about 56 percent compliance; that's $5 billion a year we are losing in taxes. When you get down to tips and things of that kind, it's even less. Then you get into the so-called illegal sector of tax compliance—drugs, prostitution, and gambling—and you get even less. I think maybe some pay it by mistake. But it is hardly perceptible when you get into those areas.

So, we are going to have a good hearing. We have some outstanding witnesses today. I appreciate the chance to make an opening statement.

Senator GRASSLEY. Thank you, Senator Dole. And I want to thank you and your staff for the help and contribution that you have made in putting together what I think is a piece of legislation that ought to pass with little controversy, especially compared to the controversy that it could have engendered without the fine groundwork that was laid.

Senator Danforth is necessarily away from the committee, and he has a statement that will be submitted for the record.

I would like to call on Commissioner Egger.

Would you start, please? Then we will hear from all three of you before we ask questions.

## STATEMENT OF HON. ROSCOE L. EGGER, JR., COMMISSIONER OF INTERNAL REVENUE, WASHINGTON, D.C.

Commissioner EGGER. Thank you, Mr. Chairman.

I appreciate very much the opportunity to appear here today to discuss the compliance tax gap. I am pleased that you have chosen to grapple with this tough issue, and I am particularly gratified by the interest of Senators Dole and Grassley, who have attempted to find legislative solutions to this problem by focusing on methods to collect tax from those who are not paying their fair share, without imposing new tax burdens on those who already voluntarily comply with the tax laws.

In my testimony, I will attempt to briefly review the various components of this tax gap, point out the Service's efforts to deal with these areas, and indicate what additional legislative measures would be helpful to us. To assist me here today, I have Jim Owens, our Deputy Commissioner.

The term "tax gap" as I will use it here today is meant to apply to all revenue lost to the U.S. Treasury through noncompliance with our tax laws. As such, it includes losses from unreported income and underreported income, as well as overstated expenses, deductions, and exemptions claimed on filed returns. It covers revenues lost from the noncompliance by corporations and by individuals in both the legal sector and the illegal sector of our economy.

The Service has been deeply concerned with this issue for some years, and issued a formal report on it called "Estimates of Income Unreported on Individual Income Tax Returns." This report was issued in September of 1979. The report introduced two terms mentioned earlier which I would like to define now for our collective ease of reference.

First, "Legal Sector" which includes earnings and income from regularly established enterprises or occupations and from legal activities that are sometimes called irregular because they take place in informal settings. Examples of these legal earnings are unreported interest and dividends, unreported tips, and unreported earnings of independent contractors and other individuals.

By comparison, "Illegal Sector" incomes are those derived from organizing, financing, producing, and delivering illegal goods or services related to drugs, gambling, prostitution, and so on. Estimates in this sector are particularly difficult to obtain, needless to say.

The Service is working now to update the data in the 1979 report, and we expect to have the new report available this summer. One definitional change we will be making in the new report will be to distinguish our estimates between amounts related to underreporting or nonreporting and amounts related to the overstatement of expenses or deductions. We believe this differentiation is essential in guiding the Service's enforcement efforts to the areas of greatest opportunity. Additional changes include a new analysis of the corporate sector tax gap, coverage of more tax years, and more sophisticated methodology generally. I have included a more detailed description of these differences as an appendix to this statement.

I am prepared to discuss some of our preliminary findings and data from the new report today, although I must caution that the figures I have now may be revised somewhat in our final report. The bulk of the data now available relates to individuals. Detailed information on corporations and the illegal sector will not be available until later this year. I also have information on the size and the scope of the accounts receivable problem facing us, which we perceive as an important part of our overall compliance effort, even though not an integral part of the tax gap per se.

The tax gap has been a problem for years, but recently the dollars involved have reached alarming levels. Our latest estimate is that the total legal sector gap has tripled in 8 years, from $29 billion in 1973 to $87 billion in 1981. Our projections are that this legal sector tax gap will continue to increase if no improvements are made, and will reach nearly $120 billion in 1985. At the same time, the gap in the illegal sector has increased from about $2.5 billion in 1973 to $8 billion in 1981, with a projected increase to $13 billion by 1985.

In addition to these tax gap estimates, we have approximately $20.5 billion from cases in our 1981 accounts receivable inventory. These are amounts owed by taxpayers which in the past we have not been able to collect, largely because of inadequate resources. I am pleased to report here today that the revenue initiative in our 1983 budget proposal should allow us to reduce this inventory considerably.

Despite the magnitude of the problem, I cannot emphasize too strongly that most taxpayers in this country are conscientious and that the tax system is basically sound and reliable. The tax reported voluntarily—that is, without any enforcement effort—is approximately 80 percent of the total taxes owed. We should not overlook, however, the fact that this voluntary compliance results largely from a good set of tax administration rules based on withholding and information reporting, and a tradition of effective and fair tax administration.

The Service is committed to studying areas of noncompliance on a continuing basis to improve what is, by any measure, one of the finest tax systems in the world.

I believe the Dole-Grassley bill has taken a major, positive step in this direction. This bill would provide several much-needed extensions of information reporting requirements and would provide penalties designed to give current rules more teeth. I am convinced that only as we focus on those areas where taxpayers are not reporting their full tax liability can we assure honest taxpayers that others are paying their fair share of taxes.

Now, Mr. Chairman, I would like to briefly review the various components of the tax gap as we see them. I will also attempt to indicate, for each component, our area of greatest concern and additional measures which would assist us in these problem areas.

Perhaps it would be helpful, conceptually, at least, to view the tax gap as a sort of real-life Rubik's Cube; that is, the tax gap is multidimensional and is composed of a number of interrelated parts. Efforts aimed at one aspect of the tax gap may not be suitable or even relevant to other aspects. Most importantly, however, the problem must be visualized in its entirety for maximum comprehension.

Because the largest portion of the tax gap is from legal income that is not reported by individuals, I will concentrate, in the discussion of each component, on the tax gap arising from unreported income by individual taxpayers. In discussing each component I will try to give you an idea of the estimated revenue lost from the underreporting. Our final report will contain more information on the revenue lost as the result of overstated deductions and credits by individuals, and more information on the corporate and legal returns filed because we are still developing information on the income sources of nonfilers.

The largest single category of unreported income is from individual nonfarm business activities, which in 1981 accounted for $26 billion or 31 percent of the total tax gap. This category includes unreported income from a large number of small transactions at the retail level, nonreporting of payments received by independent contractors, and receipts from direct or door-to-door sales. About 20 percent of it comes from self-employed moonlighters and informal suppliers who provide goods and services. The other 80 percent comes from what we call the formal sector, which includes full-time sole proprietorships; for example, physicians, lawyers, retail store operators, building contractors, salesmen, et cetera.

Very little of this income is required to be reported under current information-reporting requirements. Even where reporting is required, compliance by payers is poor, and some of these who do report provide inadequate or inaccurate information. When the inaccurate information is the taxpayer identification number of the payee, it makes it very difficult for the Service to use the information.

A recent study of small- and medium-sized corporate payers revealed that about 50 percent of these corporations failed to file any of the form 1099 MISC's required, and another 11 percent did not file all the documents. More importantly, when we followed up to see if the recipient of the income had reported the payments, we found that compliance by payees who did not receive information statements was considerably lower than by those who did.

The employee-independent contractor area is particularly in need of congressional attention. Since 1979 Congress has prohibited the IRS from issuing regulations and rulings in this area. Our ability to make a significant dent in the tax gap from independent contractors and direct sellers is largely dependent on congressional action. We will be testifying shortly in more detail on this problem.

The tax compliance problem with farm income reported on tax returns is primarily the overstatement of business deductions. This also is an area that is normally dealt with through our regular examination program.

The second largest unreported income area is capital gains, which accounted for $9.1 billion of the tax gap for 1981 or 11 percent of the total tax gap, compared to $2 billion or 7½ percent in 1973. This growth is related closely to the effect of inflation on asset values and on taxpayer behavior.

At the present time there is no information reporting requirement on most of the transactions giving rise to capital gains. Certain portions of underreporting in this area could be addressed by information reporting. This is particularly true for underreporting of the gains directly attributable to the sale of securities and commodities. We realize, of course, that this is only one conceptual approach to the problem, and we anticipate further study to determine what information could be obtained readily and how that information would be most useful to the Service.

Other portions of this component may be more difficult to get at legislatively, such as the substantial underreporting of gains on the sale of personal residences and on other real estate; gains on the sale of collectibles such as gold and silver, gems, and art objects; gains on timber and livestock; and sale of property used in a trade or business. One administrative technique we are beginning to perfect for selected items in this category is our deferred adverse tax consequences program. Using this program, we can track the deferral of tax consequences from one return year to another. For example, deferred gains on the sale of residences could be tracked to insure that the cost basis of replacement residences are reduced accordingly.

We are also undertaking a research project which would test the feasibility of using private sector data on real estate transactions to insure correct reporting of such sales on tax returns.

The tax gap for unreported and underreported dividends and interest is estimated at $8.2 billion in 1981 for filers and nonfilers together; $7.8 billion of this is for the filers only. This is an increase of 356 percent from the estimated gap for both groups of $1.8 billion in 1973.

Approximately 37 percent of the dividend and interest tax gap is due to the failure of individuals to report dividend and interest payments that are covered under current information reporting requirements.

In addition, approximately 26 percent of the tax gap in this component results from current law which exempts major payers, including the U.S. Government, from reporting interest on bearer securities and other debt obligations.

The only way to achieve maximum compliance here, however, is through a withholding system. As a tax administrator, I am pleased that this administration has endorsed the concept of withholding.

Taken together, these income sources represent the third most important source of the unreported income tax gap at about $7.2 billion, or about 9 percent of the total tax gap from individual income tax returns for 1981. This is a substantial increase from the $1.9 billion of 1973, and most of these increases come from partnerships, versus the electing small business corporations.

While underreporting of income by partnerships and electing small business corporations is clearly a substantial problem, perhaps equally important is the overstatement of expenses and deductions. One of the reasons for the growth in this portion of the problem is the increase in the number of persons willing to play the audit lottery. This can be defined as a game played by a growing number of taxpayers and practitioners in which they report items on their return in a manner clearly inconsistent with established Service position or judicial interpretation of the law or the regulations as applied to the taxpayer's circumstances.

These practices are coupled with the reporting of sufficient information to preclude the imposition of the fraud or negligence penalty, but not sufficient to clearly indicate the nature of the item.

Taxpayers do this for two basic reasons: First, the probability of their return being selected for audit is very small. Second, and probably more important, the taxpayer's risk is generally limited to the interest on the deficiency that might be determined.

While the Economic Recovery Tax Act provision for an addition to the tax in cases of valuation overstatement will undoubtedly help discourage the audit lottery, much more needs to be done. We need to further increase the risk to persons who are inclined to play this game.

Perhaps the biggest administrative problem the IRS encounters in auditing returns of partners is the requirement to deal separately with the return for each member in a partnership. This encourages promoters of abusive tax shelters to structure their schemes as partnerships that are multitiered, with wide geographic dispersion of partners. Because of this, we often argue the same issues many times over. We believe that partnerships should have a separate statute of limitations for partnership items; single audit and administrative appeals proceedings should take place in the IRS district where the partnership is located; and the partnership should have a single judicial proceeding to contest an IRS partnership adjustment.

The tax gap from pensions is estimated to be about $2.8 billion in 1981, which is a fourfold increase from the $700 million in 1973. Underreporting in this area can be expected to grow even more in the future. This results from several factors: One is a general rise in the percent of the U.S. population past retirement age; a second is the expansion of pension or retirement plans; a third factor is the complexity faced by a retiree in attempting to determine such things as how much of the pension to report and, for many, how to comply with the estimated tax payment rules.

It is important to note here that when we refer to pensions, we are not speaking of the social security system. We are only speaking of pensions arising from employer or union pension plans, and from IRA's, annuity plans, deferred compensation plans, et cetera. Given these complexities, the simplest way to insure full reporting in this area is through a withholding system. Since such a system would be very similar to the present graduated withholding system it should be very easy to develop. In much the same way the initial institution of the withholding system was viewed as a service to wage earners, we believe institution of a simliar system for pensioners can be viewed as a benefit, enabling them to continue meeting their tax obligations on a pay-as-you-go basis with a minimum impact on the individuals.

In the wage and salary area, while the dollar amount of the tax gap from unreported income, approximately $4.8 billion in 1981, is large, the revenue loss from wages and salaries and other related employee compensation represents only 1 percent noncompliance for wages as a whole. This extremely high compliance effort is directly attributable to withholding. Much of the noncompliance in this component is from cash payments made to so-called casual employees or moonlighters and other household and agricultural workers. In these circumstances, neither reporting nor withholding is generally required; even if it is, it does not occur. There is no paper trail to follow in our enforcement activities, and we have an extremely difficult time trying to uncover noncompliance.

The second major source of noncompliance with wage reporting is from tips. We estimate that the tax gap from tips alone was approximately $2.3 billion in 1981, nearly one half of the total unreported income in this component. Most of the noncompliance here occurs because of our currently loose information reporting with withholding requirements, which only require employers to report and withhold on the tip income voluntarily reported to them by their employees. Since some portion of tips are charged on credit cards and thus recorded as such on the charge statement, we believe employers should at least be responsible for reporting these amounts to the IRS.

The tax gap components I have covered up to now have mainly involved underreporting in returns filed. An equally serious problem, however, is nonfilers—those who simply do not file a return, but should. This could be anyone, anywhere in the tax system.

The tax gap for nonfilers is responsible for $4.9 billion or 6 percent of the total individual tax gap. However, the tax gap from nonfilers has grown four times since 1973 compared to about three times for the tax gap on returns filed. Current law imposes a penalty for delinquent filing only if the taxpayer owes a tax. Many nonfilers, however, are either owed a refund or owe no tax. In trying to secure delinquent returns, we cannot distinguish between those who owe tax and those who do not. The imposition of a minimum penalty for failing to file would help achieve better compliance with the filing requirements and should help offset the substantial administrative costs of attempting to locate taxpayers who fail to file even if only for their refunds.

Another aspect of the nonfiling problem is that created by illegal tax protestors. These individuals often fail to file returns as a conscious way of protesting against the tax system. Alternatively, they file fraudulent withholding requests on form W-4 to reduce or actually eliminate amounts taken from their salaries. The new Economic Recovery Tax Act penalty of $500 for filing false W-4's will certainly aid our enforcement efforts in this area. However, as a result of our compliance efforts in this area, a burden has been placed on some employers who are now finding that, by complying with IRS withholding instructions, they are being subjected to unfounded lawsuits by the protestors.

I believe it is unfair to make employers shoulder the burden and expense of these lawsuits, and it seems clear that the IRS and the Justice Department's efforts to act as friends of the court are not enough. Therefore, I would urge the committee to consider adding a provision to this legislation to effectively deal with this problem. We would be happy to work with you and the committee on this point.

Our recent work in the corporate area has indicated that our major problem involves overstatement of expenses, deductions, and credits. However, estimates in this area are extremely difficult to develop. Precise numbers will be included in our final report. The Service's efforts in this area have been focused on the large corporations. Virtually all of them are audited on a 3-year cycle. For many small corporations, however, the earlier discussion on the audit lottery and the lack of penalties applies equally as well here as in the partnership area.

Our estimates of the illegal sector were developed in conjunction with the work of the National Narcotics Intelligence Consumers Committee and include the tax gap from illegal drugs, gambling, and prostitution. We are working to develop estimates in other areas such as white collar crime, but we do not know when we will have usable results.

Because precise estimates in this sector are difficult to obtain, we can only estimate within a range of possibilities. The estimated tax gap in this illegal sector is between $6 billion and $10 billion in 1981, compared to $2 billion to $3 billion in 1973. Most of this increase is due to an increase in income from illegal drugs.

We have testified earlier in support of two provisions that we believe would aid us substantially in combating tax losses from the illegal sector. The first of these provisions would amend IRC section 7609 to require taxpayers who wish to challenge a summons issued to a third-party recordkeeper to file a motion to quash. This change will eliminate the present delays in enforcing a third-party summons caused when the Service must get a U.S. attorney to go to court to enforce the summons. The second provision would insure that evidence of civil tax liability obtained by a grand jury as part of a criminal investigation would be made available to the Service.

Many of the provisions in this legislation will have wide-ranging impacts on both the private sector and the Service. In particular, our administrative data processing operations will be directly affected. Efficient implementation of your proposals will require that adequate leadtime be provided all concerned parties, regardless of what the exact dates are. We will be pleased to work with you and the committee staff, as necessary, to refine the necessary leadtimes involved.

Without question, the single most effective and fairest means of closing the tax gap and insuring high levels of compliance is withholding at the source. IRS estimates indicate that where there is withholding, compliance is in the 97- to 99-percent range.

Information reporting is the next most effective approach for insuring high levels of income reporting compliance, but only when the taxpayer receives a copy of the information report and when complemented by IRS matching and enforcement programs. As I have discussed above, there are clearly additional areas to which the concepts of information reporting can be extended. Where information reporting alone is relied on, compliance drops to something less than 90 percent.

To insure the full effectiveness of information reporting to the Service, however, several other factors must be considered. First, the information should also be sent to the payee. Unless a copy of what was sent to the IRS reaches the taxpayer at the time that he or she completes the return, it can too easily be forgotten.

Second, there must be effective penalties on payers to insure that all information is in fact reported and that they obtain correct taxpayer identification numbers from the payees. As I discussed earlier, most of our recent research indicates that there currently is a substantial degree of noncompliance by payers with the present reporting requirements. While we are taking steps administratively to begin to deal with this problem, the additional penalties in the bill are needed.

A third factor that impacts our ability to use information returns is the format in which it is submitted. If the information is sent on magnetic media, we are generally able to match 100 percent, but if it is sent on paper documents the percentage we are able to match is much lower. We have been quite successful in getting businesses to use magnetic media on a voluntary basis, but we believe giving the Service the authority to set standards in this area that will improve substantially our ability to administer the information returns program in the future.

Where neither withholding nor information reporting is prescribed, and the IRS must rely on its auditing efforts alone, compliance in the range of 60 to 80 percent can be expected. Traditional examination enforcement efforts should, in my view, be limited to those areas where they are most preferable or the only available option.

To an extent, tax gaps can be closed by more effective enforcement and by a commitment of additional enforcement resources. A significant portion of the gap, however, is simply not amenable to traditional examinations and audits.

All things considered, extension of withholding provisions provide the surest way of closing certain tax gaps. Expanded information reporting with appropriate penalties can also be very effective, particularly as the IRS further expands its ADP capabilities.

Additional or increased penalties which reflect current economic realities and deter current faddish forms of noncompliance also close the door quickly on certain tax gap problem areas.

Again, Mr. Chairman, I thank you for letting me appear before this committee. I hope I have given you a context for our position, and I will leave it to Mr. Chapoton to discuss the specific provisions of the proposed legislation.

[The prepared statement follows:]

STATEMENT OF
ROSCOE L. EGGER, JR.
COMMISSIONER OF INTERNAL REVENUE
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE INTERNAL REVENUE SERVICE
COMMITTEE ON FINANCE

MARCH 22, 1982

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY TO DISCUSS THE COMPLIANCE "TAX GAP." I AM PLEASED THAT YOU HAVE CHOSEN TO GRAPPLE WITH THIS TOUGH ISSUE, AND I AM PARTICULARLY GRATIFIED BY THE INTEREST OF SENATORS DOLE AND GRASSLEY, WHO HAVE ATTEMPTED TO FIND LEGISLATIVE SOLUTIONS TO THIS PROBLEM BY FOCUSING ON METHODS TO COLLECT TAX FROM THOSE WHO ARE NOT PAYING THEIR FAIR SHARE, WITHOUT IMPOSING NEW TAX BURDENS ON THOSE WHO ALREADY VOLUNTARILY COMPLY WITH THE TAX LAWS.

IN MY TESTIMONY, I WILL ATTEMPT TO BRIEFLY REVIEW THE VARIOUS COMPONENTS OF THE TAX GAP, POINT OUT THE SERVICE'S EFFORTS TO DEAL WITH THESE AREAS, AND INDICATE WHAT ADDITIONAL LEGISLATIVE MEASURES WOULD BE HELPFUL TO US. TO ASSIST ME, I HAVE JIM OWENS, OUR DEPUTY COMMISSIONER, HERE TODAY.

## DEFINITION OF THE TAX GAP AND RELATED ITEMS

THE TERM "TAX GAP" AS I WILL USE IT HERE TODAY IS MEANT TO APPLY TO ALL REVENUE LOST TO THE U.S. TREASURY THROUGH NONCOMPLIANCE WITH OUR TAX LAWS. AS SUCH, IT INCLUDES LOSSES FROM UNREPORTED INCOME AND UNDERREPORTED INCOME, AS WELL AS OVERSTATED EXPENSES, DEDUCTIONS, AND EXEMPTIONS CLAIMED ON FILED RETURNS. IT COVERS REVENUES LOST FROM NONCOMPLIANCE BY CORPORATIONS AND BY INDIVIDUALS IN BOTH THE LEGAL SECTOR AND THE ILLEGAL SECTOR OF THE ECONOMY.

THE SERVICE HAS BEEN DEEPLY CONCERNED WITH THIS ISSUE FOR SOME YEARS, AND ISSUED A FORMAL REPORT ON IT, ESTIMATES OF INCOME UNREPORTED ON INDIVIDUAL INCOME TAX RETURNS, IN SEPTEMBER 1979. THE REPORT INTRODUCED TWO TERMS MENTIONED EARLIER WHICH I WOULD LIKE TO DEFINE NOW FOR OUR COLLECTIVE EASE OF REFERENCE. "LEGAL SECTOR" EARNINGS INCLUDE INCOMES FROM REGULARLY ESTABLISHED ENTERPRISES OR OCCUPATIONS, AND FROM LEGAL ACTIVITIES THAT ARE SOMETIMES CALLED IRREGULAR BECAUSE THEY TAKE PLACE IN INFORMAL SETTINGS. EXAMPLES OF THESE LEGAL EARNINGS ARE UNREPORTED INTEREST AND DIVIDENDS, UNREPORTED TIPS, AND UNREPORTED EARNINGS OF INDEPENDENT CONTRACTORS AND OTHER INDIVIDUALS. BY COMPARISON, "ILLEGAL SECTOR" INCOMES ARE THOSE DERIVED FROM ORGANIZING, FINANCING, PRODUCING, AND DELIVERING ILLEGAL GOODS OR SERVICES RELATED TO DRUGS, GAMBLING, PROSTITUTION, AND SO ON. ESTIMATES IN THIS SECTOR ARE PARTICULARLY DIFFICULT TO OBTAIN, NEEDLESS TO SAY.

THE SERVICE IS WORKING NOW TO UPDATE THE DATA IN THE 1979 REPORT, AND EXPECTS TO HAVE THE NEW REPORT AVAILABLE THIS SUMMER. ONE DEFINITIONAL CHANGE WE WILL BE MAKING IN THE NEW REPORT WILL BE TO DISTINGUISH IN OUR ESTIMATES BETWEEN AMOUNTS RELATED TO UNDERREPORTING OR NON-REPORTING, AND AMOUNTS RELATED TO THE OVERSTATEMENT OF EXPENSES OR DEDUCTIONS. WE BELIEVE THIS DIFFERENTIATION IS ESSENTIAL IN GUIDING THE SERVICE'S ENFORCMENT EFFORTS TO THE AREAS OF GREATEST OPPORTUNITY. ADDITIONAL CHANGES INCLUDE A NEW ANALYSIS OF THE CORPORATE SECTOR TAX GAP, COVERAGE OF MORE TAX YEARS (1973-1981), AND MORE SOPHISTICATED METHODOLOGY GENERALLY. I HAVE INCLUDED A MORE DETAILED DESCRIPTION OF THESE DIFFERENCES AS AN APPENDIX TO THIS STATEMENT.

I AM PREPARED TO DISCUSS SOME OF OUR PRELIMINARY FINDINGS AND DATA FROM THE NEW REPORT TODAY, ALTHOUGH I MUST CAUTION YOU THAT THE FIGURES I HAVE NOW MAY BE REVISED IN OUR FINAL REPORT. THE BULK OF THE DATA NOW AVAILABLE RELATES TO INDIVIDUALS, AND DETAILED INFORMATION ON CORPORATIONS AND THE ILLEGAL SECTOR WILL NOT BE AVAILABLE UNTIL LATER THIS YEAR. I ALSO HAVE INFORMATION ON THE SIZE AND SCOPE OF THE ACCOUNTS RECEIVABLE PROBLEM FACING US, WHICH WE PERCEIVE AS AN IMPORTANT PART OF OUR OVERALL COMPLIANCE EFFORT, IF NOT AN INTEGRAL PART OF THE TAX GAP PER SE.

## OVERVIEW OF TAX GAP

THE TAX GAP HAS BEEN A PROBLEM FOR YEARS, BUT RECENTLY THE DOLLARS INVOLVED HAVE REACHED ALARMING LEVELS. OUR LATEST ESTIMATE IS THAT THE TOTAL LEGAL SECTOR GAP HAS TRIPLED IN EIGHT YEARS, FROM $29 BILLION IN 1973 TO $87 BILLION IN 1981. OUR PROJECTIONS ARE THAT THIS LEGAL SECTOR TAX GAP WILL CONTINUE TO INCREASE, IF NO IMPROVEMENTS ARE MADE, AND WILL REACH NEARLY $120 BILLION IN 1985. AT THE SAME TIME, THE GAP IN THE ILLEGAL SECTOR HAS INCREASED FROM ABOUT $2 1/2 BILLION IN 1973 TO $8 BILLION IN 1981, WITH A PROJECTED INCREASE TO $13 BILLION IN 1985.

IN ADDITION TO THESE TAX GAP ESTIMATES, WE HAVE APPROXIMATELY $20.5 BILLION DOLLARS FROM CASES IN OUR 1981 ACCOUNTS RECEIVABLE INVENTORY. THESE ARE AMOUNTS OWED BY TAXPAYERS WHICH IN THE PAST WE HAVE NOT BEEN ABLE TO COLLECT, LARGELY BECAUSE OF INADEQUATE RESOURCES. I AM PLEASED TO REPORT THAT THE REVENUE INITIATIVE IN OUR 1983 BUDGET SHOULD ALLOW US TO REDUCE THIS INVENTORY.

DESPITE THE MAGNITUDE OF THE PROBLEM, I CAN'T EMPHASIZE TOO STRONGLY THAT MOST TAXPAYERS ARE CONSCIENTIOUS, AND THAT THE TAX SYSTEM IS BASICALLY SOUND AND RELIABLE. THE TAX REPORTED VOLUNTARILY - THAT IS, WITHOUT ANY ENFORCEMENT EFFORT - IS APPROXIMATELY 80 PERCENT OF WHAT IS OWED. WE SHOULD NOT OVERLOOK, HOWEVER, THE FACT THAT THIS VOLUNTARY

COMPLIANCE RESULTS LARGELY FROM A GOOD SET OF TAX ADMINISTRATION RULES BASED ON WITHHOLDING AND INFORMATION REPORTING, AND A TRADITION OF EFFECTIVE AND FAIR TAX ADMINISTRATION.

THE SERVICE IS COMMITTED TO STUDYING AREAS OF NONCOMPLIANCE ON A CONTINUING BASIS TO IMPROVE WHAT IS, BY ANY MEASURE, ONE OF THE FINEST TAX SYSTEMS IN THE WORLD. I BELIEVE THE DOLE-GRASSLEY BILL HAS TAKEN A MAJOR, POSITIVE STEP IN THIS DIRECTION. THIS BILL WOULD PROVIDE SEVERAL MUCH-NEEDED EXTENSIONS OF INFORMATION REPORTING REQUIREMENTS, AND WOULD PROVIDE PENALTIES DESIGNED TO GIVE CURRENT RULES MORE TEETH. I AM CONVINCED THAT ONLY AS WE FOCUS ON THOSE AREAS WHERE TAXPAYERS ARE NOT REPORTING THEIR FULL TAX LIABILITY CAN WE ASSURE HONEST TAXPAYERS THAT EVERYONE IS PAYING THEIR FAIR SHARE.

## COMPONENTS OF THE TAX GAP

NOW, MR. CHAIRMAN, I WOULD LIKE TO BRIEFLY REVIEW THE VARIOUS COMPONENTS OF THE TAX GAP AS WE SEE THEM. I WILL ALSO ATTEMPT TO INDICATE, FOR EACH COMPONENT, OUR AREA(S) OF GREATEST CONCERN AND THE ADDITIONAL MEASURES WHICH WOULD ASSIST US IN THESE PROBLEM AREAS.

PERHAPS IT WOULD HELP CONCEPTUALLY TO VIEW THE TAX GAP AS A SORT OF REAL-LIFE RUBIK'S CUBE. THAT IS, THE TAX GAP IS MULTI-DIMENSIONAL, AND IS COMPOSED OF A NUMBER OF INTERRELATED

PARTS. EFFORTS AIMED AT ONE ASPECT OF THE TAX GAP MAY NOT BE SUITABLE, OR EVEN RELEVANT, TO OTHER ASPECTS. MOST IMPORTANTLY, HOWEVER, THE PROBLEM MUST BE VISUALIZED IN ITS ENTIRETY FOR MAXIMUM COMPREHENSION.

BECAUSE THE LARGEST PORTION OF THE TAX GAP IS FROM LEGAL INCOME THAT IS NOT REPORTED BY INDIVIDUALS, I WILL CONCENTRATE IN THE DISCUSSION OF EACH COMPONENT ON THE TAX GAP ARISING FROM UNREPORTED INCOME BY INDIVIDUAL TAXPAYERS. IN DISCUSSING EACH COMPONENT, I WILL TRY TO GIVE YOU AN IDEA OF THE ESTIMATED REVENUE LOST FROM THE UNDERREPORTING. OUR FINAL REPORT WILL CONTAIN MORE INFORMATION ON THE REVENUE LOST AS A RESULT OF OVERSTATED DEDUCTIONS AND CREDITS BY INDIVIDUALS AND MORE INFORMATION ON THE CORPORATE AND ILLEGAL SECTORS. UNLESS OTHERWISE NOTED, THESE FIGURES DEAL ONLY WITH RETURNS FILED, BECAUSE WE ARE STILL DEVELOPING INFORMATION ON THE INCOME SOURCES OF NONFILERS.

1. <u>FARM AND NON-FARM BUSINESSES</u>

THE LARGEST SINGLE CATEGORY OF UNREPORTED INCOME IS FROM INDIVIDUAL NONFARM BUSINESS ACTIVITIES, WHICH IN 1981 ACCOUNTED FOR $26 BILLION OR 31 PERCENT OF THE TOTAL TAX GAP. THIS CATEGORY INCLUDES UNREPORTED INCOME FROM A LARGE NUMBER OF SMALL TRANSACTIONS AT THE RETAIL LEVEL, NONREPORTING OF PAYMENTS RECEIVED BY INDEPENDENT CONTRACTORS, AND RECEIPTS FROM DIRECT OR

DOOR TO DOOR SALES. ABOUT 20 PERCENT OF IT COMES FROM SELF-EMPLOYED MOONLIGHTERS AND "INFORMAL SUPPLIERS" WHO PROVIDE GOODS AND SERVICES. THE OTHER 80 PERCENT COMES FROM WHAT WE CALL THE FORMAL SECTOR, WHICH INCLUDES FULL TIME SOLE PROPRIETORSHIPS - FOR EXAMPLE, PHYSICIANS, LAWYERS, RETAIL STORE OPERATORS, BUILDING CONTRACTORS, SALESMEN, ETC.

VERY LITTLE OF THIS INCOME IS REQUIRED TO BE REPORTED UNDER CURRENT INFORMATION REPORTING REQUIREMENTS. EVEN WHERE REPORTING IS REQUIRED, COMPLIANCE BY PAYERS IS POOR, AND SOME OF THESE WHO DO REPORT PROVIDE INADEQUATE OR INACCURATE INFORMATION. WHEN THE INACCURATE INFORMATION IS THE TAXPAYER IDENTIFICATION NUMBER OF THE PAYEE, IT MAKES IT VERY DIFFICULT FOR THE SERVICE TO USE THE INFORMATION.

A RECENT STUDY OF SMALL AND MEDIUM SIZED CORPORATE PAYERS REVEALED THAT ABOUT 50 PERCENT OF THESE CORPORATIONS FAILED TO FILE ANY OF THE FORMS 1099 MISC'S REQUIRED, AND ANOTHER 11 PERCENT DID NOT FILE ALL THE DOCUMENTS. MORE IMPORTANTLY, WHEN WE FOLLOWED UP TO SEE IF THE RECIPIENT OF THE INCOME HAD REPORTED THE PAYMENTS, WE FOUND THAT COMPLIANCE BY PAYEES WHO DID NOT RECEIVE INFORMATION STATEMENTS WAS CONSIDERABLY LOWER THAN BY THOSE WHO DID.

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THE EMPLOYEE-INDEPENDENT CONTRACTOR AREA IS PARTICULARLY IN NEED OF CONGRESSIONAL ATTENTION. SINCE 1979, CONGRESS HAS PROHIBITED THE IRS FROM ISSUING REGULATIONS AND RULINGS IN THIS AREA. OUR ABILITY TO MAKE A SIGNIFICANT DENT IN THE TAX GAP FROM INDEPENDENT CONTRACTORS AND DIRECT SELLERS IS LARGELY DEPENDENT ON CONGRESSIONAL ACTION. WE WILL BE TESTIFYING SHORTLY IN MORE DETAIL ON THIS PROBLEM.

THE TAX COMPLIANCE PROBLEM WITH FARM INCOME REPORTED ON TAX RETURNS IS PRIMARILY THE OVERSTATEMENT OF BUSINESS DEDUCTIONS. THIS ALSO IS AN AREA THAT IS NORMALLY DEALT WITH THROUGH OUR EXAMINATION PROGRAM.

2. CAPITAL GAINS

THE SECOND LARGEST UNREPORTED INCOME AREA IS CAPITAL GAINS, WHICH ACCOUNTED FOR $9.1 BILLION OF THE TAX GAP FOR 1981 OR 11 PERCENT OF THE TOTAL TAX GAP FROM INDIVIDUALS, COMPARED TO $2 BILLION OR 7 1/2 PERCENT IN 1973. THIS GROWTH IS RELATED CLOSELY TO THE EFFECT OF INFLATION ON ASSET VALUES AND ON TAXPAYER BEHAVIOR.

AT THE PRESENT TIME, THERE IS NO INFORMATION REPORTING REQUIREMENT ON MOST OF THE TRANSACTIONS GIVING RISE TO CAPITAL GAINS. CERTAIN PORTIONS OF

UNDERREPORTING IN THIS AREA COULD EASILY BE ADDRESSED BY INFORMATION REPORTING. THIS IS PARTICULARLY TRUE FOR UNDERREPORTING OF THE GAINS DIRECTLY ATTRIBUTABLE TO THE SALE OF SECURITIES AND COMMODITIES. WE REALIZE, OF COURSE, THAT THIS IS ONLY ONE CONCEPTUAL APPROACH TO THE PROBLEM, AND ANTICIPATE FURTHER STUDY TO DETERMINE WHAT INFORMATION COULD BE OBTAINED READILY, AND HOW THAT INFORMATION WOULD BE MOST USEFUL TO THE SERVICE.

OTHER PORTIONS OF THIS COMPONENT MAY BE MORE DIFFICULT TO GET AT LEGISLATIVELY, SUCH AS THE SUBSTANTIAL UNDERREPORTING OF GAINS ON THE SALE OF PERSONAL RESIDENCES AND ON OTHER REAL ESTATE; GAINS ON THE SALE OF COLLECTIBLES, SUCH AS GOLD AND SILVER, GEMS, AND ART OBJECTS; GAINS ON TIMBER AND LIVESTOCK; AND SALE OF PROPERTY USED IN A TRADE OR BUSINESS. ONE ADMINISTRATIVE TECHNIQUE WE ARE BEGINNING TO PERFECT FOR SELECTED ITEMS IN THIS CATEGORY IS OUR DEFERRED ADVERSE TAX CONSEQUENCES PROGRAM. USING THIS PROGRAM, WE CAN TRACK THE DEFERRAL OF TAX CONSEQUENCES FROM ONE RETURN YEAR TO ANOTHER. FOR EXAMPLE, DEFERRED GAINS ON THE SALE OF RESIDENCES COULD BE TRACKED TO INSURE THAT THE COST BASIS OF REPLACEMENT RESIDENCES ARE REDUCED ACCORDINGLY. WE ARE ALSO UNDERTAKING A RESEARCH PROJECT WHICH WOULD TEST THE FEASIBILITY OF USING PRIVATE SECTOR DATA ON REAL ESTATE TRANSACTIONS TO ENSURE CORRECT REPORTING OF SUCH SALES ON TAX RETURNS.

3. DIVIDENDS AND INTEREST

THE TAX GAP FOR UNREPORTED AND UNDERREPORTED DIVIDENDS AND INTEREST IS ESTIMATED AT \$8.2 BILLION IN 1981 FOR FILERS AND NONFILERS TOGETHER (\$7.8 BILLION FOR FILERS ONLY). THIS IS AN INCREASE OF 356 PERCENT FROM THE ESTIMATED GAP FROM BOTH GROUPS OF \$1.8 BILLION IN 1973.

APPROXIMATELY 37 PERCENT OF THE DIVIDEND AND INTEREST TAX GAP IS DUE TO THE FAILURE OF INDIVIDUALS TO REPORT DIVIDEND AND INTEREST PAYMENTS THAT ARE COVERED UNDER CURRENT INFORMATION REPORTING REQUIREMENTS.

IN ADDITION, APPROXIMATELY 26 PERCENT OF THE TAX GAP IN THIS COMPONENT RESULTS FROM CURRENT LAW, WHICH EXEMPTS MAJOR PAYERS, INCLUDING THE U.S. GOVERNMENT, FROM REPORTING INTEREST ON BEARER SECURITIES AND OTHER DEBT OBLIGATIONS.

THE ONLY WAY TO ACHIEVE MAXIMUM COMPLIANCE HERE, HOWEVER, IS THROUGH A WITHHOLDING SYSTEM. AS A TAX ADMINISTRATOR, I AM PLEASED THAT THIS ADMINISTRATION HAS ENDORSED THE CONCEPT OF WITHHOLDING.

## 4. Partnership and Electing Small Business Corporations

Taken together, these income sources represent the third most important source of the unreported income tax gap at $7.2 billion, or about 9 percent of the total tax gap from individual income tax returns for 1981. This is a substantial increase from the $1.9 billion of 1973; most of the increase comes from partnerships.

While underreporting of income by these entities is clearly a substantial problem, perhaps equally important is the overstatement of expenses and deductions. One of the reasons for the growth of this portion of the problem is the increase in the number of persons willing to play the "audit lottery." This can be defined as a game played by a growing number of taxpayers and practitioners in which they report items on their return in a manner clearly inconsistent with established Service position or judicial interpretation of the law or regulations as applied to the taxpayer's circumstances. These practices are coupled with the reporting of sufficient information to preclude the imposition of the fraud or negligence penalty, but not sufficient enough to clearly indicate the nature of the item. Taxpayers do this for two basic reasons: First, the probability of their return being selected for audit is very small. Second, and probably more important, the taxpayer's risk is generally limited to the interest on any deficiency that might be determined.

WHILE THE ECONOMIC RECOVERY TAX ACT PROVISION FOR AN ADDITION TO TAX IN CASES OF VALUATION OVERSTATEMENT SHOULD HELP DISCOURAGE THE AUDIT LOTTERY, MUCH MORE NEEDS TO BE DONE. WE NEED TO FURTHER INCREASE THE RISK TO PERSONS WHO ARE INCLINED TO PLAY THE GAME.

PERHAPS THE BIGGEST ADMINISTRATIVE PROBLEM THE IRS ENCOUNTERS IN AUDITING RETURNS OF PARTNERS IS THE REQUIREMENT TO DEAL SEPARATELY WITH THE RETURN FOR EACH MEMBER IN A PARTNERSHIP. THIS ENCOURAGES PROMOTERS OF ABUSIVE TAX SHELTERS TO STRUCTURE THEIR SCHEMES AS PARTNERSHIPS THAT ARE MULTI-TIERED, WITH WIDE GEOGRAPHIC DISPERSION OF PARTNERS. BECAUSE OF THIS, WE OFTEN ARGUE THE SAME ISSUES MANY TIMES OVER. WE BELIEVE THAT PARTNERSHIPS SHOULD HAVE A SEPARATE STATUTE OF LIMITATIONS FOR PARTNERSHIP ITEMS; SINGLE AUDIT AND ADMINISTRATIVE APPEALS PROCEEDINGS SHOULD TAKE PLACE IN THE IRS DISTRICT WHERE THE PARTNERSHIP IS LOCATED; AND THE PARTNERSHIP SHOULD HAVE A SINGLE JUDICIAL PROCEEDING TO CONTEST AN IRS PARTNERSHIP ADJUSTMENT.

5. PENSIONS

THE TAX GAP FROM PENSIONS IS ESTIMATED TO BE $2.8 BILLION IN 1981, WHICH IS A FOUR-FOLD INCREASE FROM THE $700 MILLION OF 1973. UNDERREPORTING IN THIS AREA CAN

BE EXPECTED TO GROW EVEN MORE IN THE FUTURE. THIS RESULTS FROM SEVERAL FACTORS. ONE IS A GENERAL RISE IN THE PERCENT OF THE U.S. POPULATION PAST RETIREMENT AGE; A SECOND IS THE EXPANSION OF PENSION OR RETIREMENT PLANS. A THIRD FACTOR IS THE COMPLEXITY FACED BY A RETIREE IN ATTEMPTING TO DETERMINE SUCH THINGS AS HOW MUCH OF THE PENSION TO REPORT AND, FOR MANY, HOW TO COMPLY WITH THE ESTIMATED TAX PAYMENT RULES. IT IS IMPORTANT TO NOTE HERE THAT WHEN WE REFER TO PENSIONS, WE ARE NOT SPEAKING OF THE SOCIAL SECURITY SYSTEM. WE ARE ONLY SPEAKING OF PENSIONS ARISING FROM EMPLOYER OR UNION PENSION PLANS, IRAs, ANNUITY PLANS, DEFERRED COMPENSATION PLANS, ETC.

GIVEN THESE COMPLEXITIES, THE SIMPLEST WAY TO ENSURE FULL REPORTING IN THIS AREA IS THROUGH A WITHHOLDING SYSTEM. SINCE SUCH A SYSTEM WOULD BE VERY SIMILAR TO THE PRESENT GRADUATED WITHHOLDING SYSTEM, IT SHOULD BE EASY TO DEVELOP. IN MUCH THE SAME WAY THAT INITIAL INSTITUTION OF THE WITHHOLDING SYSTEM WAS VIEWED AS A SERVICE TO WAGE EARNERS, WE BELIEVE INSTITUTION OF A SIMILAR SYSTEM FOR PENSIONERS CAN BE VIEWED AS A BENEFIT, ENABLING THEM TO CONTINUE MEETING THEIR TAX OBLIGATIONS ON A PAY-AS-YOU-GO BASIS, WITH A MINIMUM IMPACT ON THE INDIVIDUALS.

6. WAGES AND SALARIES (INCLUDING TIPS)

WHILE THE DOLLAR AMOUNT OF THE TAX GAP FROM UNREPORTED INCOME, APPROXIMATELY $4.8 BILLION IN 1981, IS LARGE, THE REVENUE LOSS FROM WAGES, SALARIES, AND OTHER RELATED EMPLOYEE COMPENSATION REPRESENTS ONLY ONE PERCENT NONCOMPLIANCE FOR WAGES AS A WHOLE. THIS EXTREMELY HIGH COMPLIANCE RATE IS DIRECTLY ATTRIBUTABLE TO WITHHOLDING.

MOST OF THE NONCOMPLIANCE IN THIS COMPONENT IS FROM CASH PAYMENTS MADE TO SO-CALLED "CASUAL" EMPLOYEES OR MOONLIGHTERS, AND OTHER HOUSEHOLD AND AGRICULTURAL WORKERS. IN THESE CIRCUMSTANCES, NEITHER REPORTING NOR WITHHOLDING IS GENERALLY REQUIRED; EVEN IF IT IS, IT DOES NOT OCCUR. THERE IS NO "PAPER TRAIL" TO FOLLOW IN OUR ENFORCEMENT ACTIVITIES, AND WE HAVE AN EXTREMELY DIFFICULT TIME IN TRYING TO UNCOVER NONCOMPLIANCE.

THE SECOND MAJOR SOURCE OF NONCOMPLIANCE WITH WAGE REPORTING IS FROM TIPS. WE ESTIMATE THAT THE TAX GAP FROM TIPS ALONE WAS APPROXIMATELY $2.3 BILLION IN 1981, NEARLY ONE HALF OF THE TOTAL UNREPORTED INCOME IN THIS COMPONENT. MOST OF THE NONCOMPLIANCE HERE OCCURS BECAUSE OF OUR CURRENTLY "LOOSE" INFORMATION REPORTING AND WITHHOLDING REQUIREMENTS, WHICH ONLY REQUIRE EMPLOYERS TO REPORT AND WITHHOLD ON THE TIP INCOME

VOLUNTARILY REPORTED TO THEM BY THEIR EMPLOYEES. SINCE SOME PORTION OF TIPS ARE CHARGED ON CREDIT CARDS, AND THUS RECORDED AS SUCH ON THE CHARGE STATEMENT, WE BELIEVE EMPLOYERS SHOULD AT LEAST BE RESPONSIBLE FOR REPORTING THESE AMOUNTS TO IRS.

7. NONFILERS

THE TAX GAP COMPONENTS I HAVE COVERED UP TO NOW HAVE MAINLY INVOLVED UNDERREPORTING IN RETURNS FILED. AN EQUALLY SERIOUS PROBLEM, HOWEVER, IS NONFILERS - THOSE WHO SIMPLY DO NOT FILE A RETURN, BUT SHOULD. THIS COULD BE ANYONE, ANYWHERE IN THE TAX SYSTEM.

THE TAX GAP FOR NONFILERS IS RESPONSIBLE FOR $4.9 BILLION OR 6 PERCENT OF THE TOTAL INDIVIDUAL TAX GAP. HOWEVER, THE TAX GAP FROM NONFILERS HAS GROWN 4 TIMES SINCE 1973 COMPARED TO ABOUT 3 TIMES FOR THE TAX GAP ON RETURNS FILED. CURRENT LAW IMPOSES A PENALTY FOR DELINQUENT FILING ONLY IF THE TAXPAYER OWES A TAX. MANY NONFILERS, HOWEVER, ARE EITHER OWED A REFUND OR OWE NO TAX. IN TRYING TO SECURE DELINQUENT RETURNS, WE CANNOT DISTINGUISH BETWEEN THOSE WHO OWE TAX AND THOSE WHO DON'T. THE IMPOSITION OF A MINIMUM PENALTY FOR FAILING TO FILE WOULD HELP ACHIEVE BETTER COMPLIANCE WITH THE FILING REQUIREMENTS AND SHOULD HELP OFFSET THE SUBSTANTIAL ADMINISTRATIVE COSTS OF LOCATING TAPAYERS WHO FAIL TO FILE FOR THEIR REFUNDS.

Another aspect of the nonfiling problem is that created by illegal tax protestors. These individuals often fail to file returns as a conscious way of protesting against the tax system. Alternatively, they file fraudulent withholding requests (Forms W-4) to reduce or actually eliminate amounts taken from their salaries. The new Economic Recovery Tax Act penalty of $500 for filing false W-4's will certainly aid our enforcement efforts in this area. However, as a result of our compliance efforts in this area, a burden has been placed on some employers who are now finding that by complying with IRS withholding instructions, they are being subjected to unfounded law suits by the protestors. I believe it is unfair to make employers shoulder the burden and expense of these law suits and it seems clear that IRS and Justice Department efforts to act as friends of the court are not enough. Therefore, I would urge the Committee to consider adding a provision to this legislation to effectively deal with this problem. We would be happy to work with you and the Committee staff on this point.

8. Corporate Tax Gap

Our recent work in the corporate area has indicated that our major problem involves the overstatement of expenses, deductions, and credits. However, estimates

IN THIS AREA ARE EXTREMELY DIFFICULT TO DEVELOP. PRECISE NUMBERS WILL BE INCLUDED IN OUR FINAL REPORT. THE SERVICE'S EFFORTS IN THIS AREA HAVE FOCUSED ON THE LARGE CORPORATIONS. VIRTUALLY ALL OF THEM ARE AUDITED ON A THREE-YEAR CYCLE. FOR MANY SMALL CORPORATIONS, HOWEVER, THE EARLIER DISCUSSION ON THE "AUDIT LOTTERY" AND THE LACK OF PENALTIES APPLIES EQUALLY AS WELL HERE AS IN THE PARTNERSHIP AREA.

9. <u>ILLEGAL SECTOR</u>

OUR ESTIMATES OF THE ILLEGAL SECTOR WERE DEVELOPED IN CONJUNCTION WITH WORK OF THE NATIONAL NARCOTICS INTELLIGENCE CONSUMERS COMMITTEE (NNICC), AND INCLUDE THE TAX GAP FROM ILLEGAL DRUGS, GAMBLING AND PROSTITUTION. WE ARE WORKING TO DEVELOP ESTIMATES IN OTHER AREAS, SUCH AS WHITE COLLAR CRIME, BUT DO NOT KNOW WHEN WE WILL HAVE USABLE RESULTS.

BECAUSE PRECISE ESTIMATES IN THIS SECTOR ARE DIFFICULT TO OBTAIN, WE CAN ONLY ESTIMATE WITHIN A RANGE OF POSSIBILITIES. THE ESTIMATED TAX GAP FOR THIS ILLEGAL SECTOR IS BETWEEN \$6 - \$10 BILLION IN 1981, COMPARED TO \$2 - \$3 BILLION IN 1973. MOST OF THIS INCREASE IS DUE TO AN INCREASE IN THE INCOME FROM ILLEGAL DRUGS.

WE HAVE TESTIFIED EARLIER IN SUPPORT OF TWO PROVISIONS THAT WE BELIEVE WOULD AID US SUBSTANTIALLY IN COMBATTING TAX LOSSES FROM THE ILLEGAL SECTOR. THE FIRST OF THESE PROVISIONS WOULD AMEND IRC SECTION 7609 TO REQUIRE TAXPAYERS WHO WISH TO CHALLENGE A SUMMONS ISSUED TO A THIRD PARTY RECORDKEEPER TO FILE A MOTION TO QUASH. THIS CHANGE WILL ELIMINATE THE PRESENT DELAYS IN ENFORCING THIRD PARTY SUMMONS CAUSED WHEN THE SERVICE MUST GET A U.S. ATTORNEY TO GO TO COURT TO ENFORCE THE SUMMONS. THE SECOND PROVISION WOULD ENSURE THAT EVIDENCE OF CIVIL TAX LIABILITY OBTAINED BY A GRAND JURY AS PART OF A CRIMINAL INVESTIGATION WOULD BE MADE AVAILABLE TO THE SERVICE.

## EFFECTIVE DATES

MANY OF THE PROVISIONS OF THIS LEGISLATION WILL HAVE WIDE-RANGING IMPACTS ON BOTH THE PRIVATE SECTOR AND THE SERVICE. IN PARTICULAR OUR ADMINISTRATIVE DATA PROCESSING OPERATIONS WILL BE AFFECTED. EFFICIENT IMPLEMENTATION OF YOUR PROPOSALS WILL REQUIRE THAT ADEQUATE LEAD TIME BE PROVIDED ALL CONCERNED PARTIES - REGARDLESS OF WHAT THE EXACT DATES ARE. WE WILL BE PLEASED TO WORK WITH YOU AND THE COMMITTEE STAFF AS NECESSARY TO REFINE THE NECESSARY LEAD TIMES INVOLVED.

REVIEW OF COMPLIANCE TECHNIQUES

WITHOUT QUESTION, THE SINGLE MOST EFFECTIVE AND FAIREST MEANS OF CLOSING THE TAX GAP AND INSURING HIGH LEVELS OF COMPLIANCE IS WITHHOLDING AT THE SOURCE. IRS ESTIMATED INDICATE THAT WHERE THERE IS WITHHOLDING, COMPLIANCE IS IN THE 97-99 PERCENT RANGE.

INFORMATION REPORTING IS THE NEXT MOST EFFECTIVE APPROACH FOR ENSURING HIGH LEVELS OF INCOME REPORTING COMPLIANCE, BUT ONLY WHEN THE TAXPAYER RECEIVES A COPY OF THE INFORMATION REPORT AND WHEN COMPLEMENTED BY IRS MATCHING AND ENFORCEMENT PROGRAMS. AS I HAVE DISCUSSED ABOVE, THERE ARE CLEARLY ADDITIONAL AREAS TO WHICH THE CONCEPTS OF INFORMATION REPORTING CAN BE EXTENDED. WHERE INFORMATION REPORTING ALONE IS RELIED ON, COMPLIANCE DROPS TO SOMETHING LESS THAN 90 PERCENT.

TO ENSURE THE FULL EFFECTIVENESS OF INFORMATION REPORTING TO THE SERVICE, HOWEVER, SEVERAL OTHER FACTORS MUST BE CONSIDERED. FIRST, THE INFORMATION SHOULD ALSO BE SENT TO THE PAYEE. UNLESS A COPY OF WHAT WAS SENT TO THE IRS REACHES THE TAXPAYER AT THE TIME HE OR SHE COMPLETES THE RETURN, IT CAN TOO EASILY BE FORGOTTEN.

SECOND, THERE MUST BE EFFECTIVE PENALTIES ON PAYERS TO ENSURE THAT ALL INFORMATION IS IN FACT REPORTED AND THAT THEY OBTAIN CORRECT TAXPAYER IDENTIFICATION NUMBERS FROM THE

PAYEES. AS I DISCUSSED EARLIER, OUR MOST RECENT RESEARCH INDICATES THAT THERE CURRENTLY IS A SUBSTANTIAL DEGREE OF NONCOMPLIANCE BY PAYERS WITH THE PRESENT REPORTING REQUIREMENTS. WHILE WE ARE TAKING STEPS ADMINISTRATIVELY TO BEGIN TO DEAL WITH THIS PROBLEM, THE ADDITIONAL PENALTIES IN THE BILL ARE NEEDED.

A THIRD FACTOR THAT IMPACTS ON OUR ABILITY TO USE INFORMATION RETURNS IS THE FORMAT IN WHICH IT IS SUBMITTED TO US. IF THE INFORMATION IS SENT ON MAGNETIC MEDIA, WE ARE GENERALLY ABLE TO MATCH 100 PERCENT OF THE INFORMATION; BUT IF IT IS SENT ON PAPER DOCUMENTS, THE PERCENTAGE WE ARE ABLE TO MATCH IS FAR LOWER. WE HAVE BEEN QUITE SUCCESSFUL IN GETTING BUSINESSES TO USE MAGNETIC MEDIA ON A VOLUNTARY BASIS, BUT BELIEVE THAT GIVING THE SERVICE THE AUTHORITY TO SET STANDARDS IN THIS AREA WILL IMPROVE SUBSTANTIALLY OUR ABILITY TO ADMINISTER THE INFORMATION RETURNS PROGRAM IN THE FUTURE.

WHERE NEITHER WITHHOLDING NOR INFORMATION REPORTING IS PRESCRIBED, AND IRS MUST RELY ON ITS AUDITING EFFORTS ALONE, COMPLIANCE IN THE RANGE OF 60-80 PERCENT CAN BE EXPECTED. TRADITIONAL EXAMINATION ENFORCEMENT EFFORTS SHOULD, IN MY VIEW, BE LIMITED TO THOSE AREAS WHERE THEY ARE THE MOST PREFERABLE OR THE ONLY AVAILABLE OPTION.

SUMMARY

TO AN EXTENT, TAX GAPS CAN BE CLOSED BY MORE EFFECTIVE ENFORCEMENT AND BY A COMMITMENT OF ADDITIONAL ENFORCEMENT RESOURCES. A SIGNIFICANT PORTION OF THE GAP, HOWEVER, IS SIMPLY NOT AMENABLE TO TRADITIONAL EXAMINATIONS AND AUDITS.

ALL THINGS CONSIDERED, EXTENSION OF WITHHOLDING PROVISIONS PROVIDE THE SUREST WAY OF CLOSING CERTAIN TAX ~~GAPS~~. EXPANDED INFORMATION REPORTING WITH APPROPRIATE PENALTIES CAN ALSO BE VERY EFFECTIVE, PARTICULARLY AS IRS FURTHER EXPANDS ITS ADP CAPABILITIES.

ADDITIONAL OR INCREASED PENALTIES WHICH REFLECT CURRENT ECONOMIC REALITIES AND DETER CURRENT FADISH FORMS OF NONCOMPLIANCE ALSO CLOSE THE DOOR QUICKLY ON CERTAIN TAX GAP PROBLEM AREAS.

AGAIN, I THANK YOU FOR LETTING ME APPEAR BEFORE THIS COMMITTEE. I HOPE I HAVE GIVEN YOU A CONTEXT FOR OUR POSITION AND I WILL LEAVE IT UP TO MR. CHAPOTON TO DISCUSS THE SPECIFIC PROVISIONS OF YOUR PROPOSED LEGISLATION.

ATTACHMENTS TO STATEMENT OF ROSCOE L. EGGER, JR. BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE, COMMITTEE ON FINANCE

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|---|---|
| ATTACHMENT I | DIFFERENCE BETWEEN THE 1979 UNREPORTED INCOME REPORT AND THE NEW TAX GAP REPORT TO BE PUBLISHED THIS SUMMER |
| ATTACHMENT II | GROSS TAX GAP FROM INDIVIDUAL INCOME TAX RETURNS FILED, NONFILERS, CORPORATE TAX AND ILLEGAL SECTOR, TAX YEARS 1973, 1976, 1979, AND 1981 |

DIFFERENCES BETWEEN THE 1979 UNREPORTED INCOME REPORT[1/]
AND THE NEW TAX GAP REPORT TO BE PUBLISHED THIS SUMMER

1. The tax gap analysis is based on a different concept from the unreported income approach of the 1979 Unreported Income Report. Consequently, both the numbers and the discussion of noncompliance relating to these concepts will differ. The current tax gap analysis, as the name implies, focuses on taxes which should be paid but are not, whether due to underreported income or overstated expenses, exemptions, deductions or other reasons. The focus of the 1979 Report was only on unreported income and its associated tax gap. The current emphasis is on the tax administration aspects of total taxes not paid--including discussions of both problems and possible solutions--not just an estimation of the tax gap associated with unreported income.

2. The new tax gap report has a different definition of unreported income from that of the Report. The Report uniformly used "net income," i.e. receipts minus all expenses and consequently included overstated business expenses as underreported income. The report generally uses gross profit (gross receipts minus cost of goods sold) as the measure of income and shows overstated expenses separately.

   Another difference in the definition of unreported income is that the current tax gap analysis shows estimates of unreported income on which tax is due (i.e., where the income is not offset by excess deductions, exemptions, credits or the tax on which is not offset by withholding) for both filers and nonfilers. The Report had reduced total unreported income by nominal amounts (with no tax consequence) only for nonfiler wages.

3. The new tax gap report also includes the corporate income tax. The previous Report dealt only with the individual income tax.

4. A new method was used in the current tax gap analysis to estimate unreported income not found by TCMP. For most items, the TCMP amount was multiplied by 3.5 to obtain the total unreported income. The ratio of unreported IRP-covered income to the amount discovered by TCMP for those items for which IRP documents were filed and available was found to be about 4.5 to 1 in a 1976 TCMP/IRP study. The multiple of 3.5 mentioned above is a conservative version of the multiple of 4.5 found in this study. The rationale of applying this ratio across the board is that if TCMP can find only $1 out of $3.50 on items for which information documents exist, it would do no better for other income items. The 1979 Report derived the non-TCMP unreported income estimates from BEA and other data sources.

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[1/] Estimates of Income Unreported on Individual Income Tax Returns, September, 1979.

5. The illegal-source estimates of unreported income are lower in the current version. In the area of illegal drug trafficking, the estimates were lowered when a review by an independent research organization concluded that the high National Narcotics Intelligence Consumers Committee (NNICC) estimates of consumption at retail prices on which the prior estimates of unreported income were based could not be justified. The estimated unreported income of those organizing illegal gambling enterprises were lowered after the FBI withdrew its endorsement of its high estimates of gross wagers used in the previous Report. A second, more important, reason for the downward revision of the illegal gambling estimates was the recommendation by an independent research group to base our estimates on a survey conducted by the University of Michigan, which previously had been thought to yield estimates that were too low.

6. The tax gap analysis was based on estimates of nonfiler incomes from Exact Match Files for 1977 as well as 1972. For the previous Report no data had yet been generated from the 1977 Exact Match File. Moreover, some errors in the previous estimates were discovered and corrected.

7. The tax gap analysis estimate of informal suppliers is based on recent University of Michigan survey data which were generated specially for the tax gap analysis. The prior estimates did not have a strong empirical base.

8. The tax gap analysis covers tax years 1973, 1976, 1979 and 1981. The 1979 Report covered only 1976.

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Gross Tax Gap from Individual Income Tax Returns Filed, Nonfilers, Corporate Tax and Illegal Sector, Tax Years 1973, 1976, 1979 and 1981
(Amounts in Billions of Dollars)

| | Amount of Tax Gap | | | |
|---|---|---|---|---|
| | 1981 | 1979 | 1976 | 1973 |
| Legal sector, total | 87.2 | 66.5 | 42.6 | 29.3 |
| Individual income tax returns, total | 83.3 | 61.8 | 39.0 | 26.5 |
| Filed returns, total | 78.4 | 58.4 | 36.8 | 25.3 |
| Income underreported: | | | | |
| Wages | 2.5 | 1.8 | .7 | .6 |
| Tips | 2.3 | 1.7 | 1.4 | .9 |
| Dividends | 3.6 | 3.1 | 1.5 | .9 |
| Interest | 4.1 | 2.9 | 1.3 | .9 |
| Capital gains | 9.1 | 8.5 | 5.1 | 2.0 |
| Nonfarm business | 26.2 | 17.5 | 11.6 | 9.6 |
| Farm business | 1.4 | 1.7 | 1.7 | 1.5 |
| Pensions | 2.8 | 2.3 | 1.1 | .7 |
| Rents | 1.5 | 1.2 | .6 | .4 |
| Royalties | 1.3 | .8 | .4 | .1 |
| Partnerships | 5.5 | 3.1 | 2.5 | 1.5 |
| Estates and trusts | .5 | .4 | .3 | .2 |
| Small business corporations | 1.7 | 1.2 | 1.2 | .4 |
| State income tax refunds | .4 | .3 | .1 | .1 |
| Alimony | .1 | * | * | * |
| Other | 3.1 | 2.4 | 1.0 | .6 |
| Total | 66.1 | 49.0 | 30.6 | 20.5 |
| Overstated expenses, deductions, credits 1/ | 12.3 | 9.4 | 6.2 | 4.8 |
| Nonfilers 1/ | 4.9 | 3.4 | 2.2 | 1.2 |
| Corporate Tax 1/ | 3.9 | 4.7 | 3.6 | 2.8 |
| Illegal sector, total 1/ 2/ | 6.1- 9.8 | 4.6- 7.4 | 2.5- 4.0 | 1.8- 2.9 |
| Drugs | 4.5- 8.1 | 3.2- 6.0 | 1.4- 2.7 | 1.0- 2.0 |
| Gambling | 0.6- 1.2 | 0.5- 0.9 | 0.4- 0.7 | 0.3- 0.5 |
| Prostitution | 0.4- 1.2 | 0.3- 1.0 | 0.3- 1.0 | 0.2- 0.7 |

1/ These are preliminary IRS figures and have not been reviewed by the Office of Tax Analysis.

2/ Total of three items below and does not include any other illegal activities.

* Less than one hundred million

Note: Details may not add to totals because of rounding.

Senator GRASSLEY. Mr. Secretary.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. CHAPOTON. Thank you, Mr. Chairman.

We are pleased to be here today to discuss the provisions of S. 2198. We think this is a particularly appropriate time to consider steps that might be taken to collect taxes due under existing law which, for a variety of reasons, currently escape taxation.

I would like to compliment the chairman for holding these hearings so quickly, and I would like to thank the chairman and other cosponsors of S. 2198 for introducing this measure. We think it takes important steps toward reducing the compliance tax gap as well as preserving the integrity of our voluntary tax compliance system.

The provisions of S. 2198 may be divided into five broad categories.

First, it deals with the information reporting requirements of existing law.

Second, it reworks the penalty structure of the Internal Revenue Code and corrects some deficiencies.

Third, it adjusts the method of computing interest on payments and on receipts by the IRS.

Fourth, it changes the method of reporting and institutes voluntary withholding of tax on retirement plan distributions.

And, fifth, it deals with some ancillary issues, particularly the Paperwork Reduction Act adopted by Congress a couple of years ago.

I will discuss each of these provisions in that order in general terms, dealing first with the reporting requirements.

Under existing law many types of payments are subject to information reporting. Most payments of interest and dividends, if they aggregate $10 or more in a year, are required to be reported on form 1099, and a copy of that form is required to be delivered to the taxpayer.

The chief class of obligations that is not covered by these reporting rules is obligations of the U.S. Government. Payments such as royalties, rents, and annuities are also subject to information reporting if they aggregate more than $600 in the year and if the payer is in a trade or business.

Wages paid to individuals are of course subject to reporting and subject to withholding. The wage withholding system has been in effect some 40 years now, and it is generally agreed that the system functions quite well.

S. 2198 will effect major changes to the tax rules governing information reporting. The thrust of these provisions is to increase the number of transactions subject to information reporting and, in conjunction with certain proposed penalty provisions, to improve the quality and usability of the information reported.

While improving and extending the information reporting network is clearly desirable, particularly to the extent that U.S. Government and corporate bearer obligations would become subject to reporting, we believe that the tax gap has grown too large for us to continue to take limited incremental steps toward improved taxpayer compliance in the interest and dividend area. For that reason, as you know, Mr. Chairman, the administration has proposed withholding on dividends and interest at source, and we hope the committee will give serious consideration to the desirability and feasibility of instituting withholding with respect to interest and dividends.

S. 2198 would also broaden the scope of information reporting in the area of charge tips, State and local government tax refunds, and capital transactions requiring reporting by commodities and securities brokers.

Turning first to tips, tips are clearly compensation and thus constitute taxable income. Current estimates show that employees report less than 20 percent of their tip income. This is simply an unsatisfactory level of taxpayer compliance. S. 2198 would require employers to treat tips that are charged on a credit card and paid over by the employer to an employee as wages subject to information reporting. Since a paper record of the transaction is already generated by the credit card, there should be little additional paperwork burden as a result of this requirement. It is, therefore, desirable to impose information reporting in these circumstances.

In the area of State tax refunds, taxpayers are required to include the refund in income if the tax was deducted in a prior year and the deduction gave rise to a tax benefit. Taxpayers frequently fail to include State and local tax refunds in income, probably because of ignorance of the requirements that they are taxable income, or, they overlook the fact that they have received the income or lack the particulars about the amount of the refund when they are preparing to file their tax returns.

The change proposed by S. 2198 would go far to remedying these problems. While we think this change is clearly desirable from the point of view of Federal tax administration, we do want to point out that one must tread carefully in imposing a requirement of even this limited nature on State and local governments, if for no other reason than out of concern for the costs to State and local governments. We do note that there has been a proliferation of information exchange agreement between the State and Federal Governments. Thus, it does not appear that it would be unduly burdensome to ask the States and localities to take the further step of insuring that taxpayers have the needed records concerning these tax refunds when they complete their tax returns.

Turning to the area of capital transactions, the tax law has long provided that the Internal Revenue Service has the authority to require information reporting by brokers of the profits and losses and other information concerning their customers. At present there are no such requirements in effect. S. 2198 would mandate the issuance of regulations requiring information reporting by commodities and securities brokers on capital transactions.

I would note, Mr. Chairman, that S. 2198 would require that this information be reported only to the IRS and not to the taxpayers. We think that the failure of taxpayers to receive information could account in large part for the high rate of noncompliance in the area of capital transactions—about 56 percent. We think, therefore, that if reporting is required for securities brokers and commodities brokers, the committee should consider the desirability of a requirement that the information be furnished to taxpayers as well as to the IRS.

The poor rate of compliance for capital transactions leads us to the conclusion that information reporting by securities and commodities brokers is desirable, but we would like an opportunity to consider certain questions that would be raised by this type of information reporting. We want to consider carefully the types of information that would be required to be furnished to make certain that it is fully useful to the IRS, and, second, we want to examine the cost to both the industry and to IRS of producing information that would be useful. We would look forward to working with the committee and the industry toward the development of workable rules.

S. 2198 would also permit the Commissioner to require that tax returns be filed in machine-processable form, including on magnetic media. At a time when businesses are increasingly relying on computers to perform basic information-processing functions, it seems appropriate to confirm that the Commissioner may require reporting in this manner.

Turning to the penalty provisions, we note that the penalty provisions of a voluntary tax compliance system must have two basic characteristics.

First, the penalties must deter taxpayer behavior that would impair voluntary tax compliance. Persons who purposely or recklessly fail to comply with the tax law must be subjected to sanctions.

Second, the penalties must take into account, through abatement processes or otherwise, reasonable errors or omissions made in good faith. This second element is particularly important given the complexity of our tax laws.

Although most taxpayers wish to pay their fair share of taxes, there is an institutionalized minority that relies on flaws in the existing penalty structure to avoid tax. They rely on two facets of the present system: Basically that the present system imposes no penalty even on an agressive position taken in a return, so long as a reasonable basis exists for the position taken; and, second, they rely on the fact that a relatively small number of tax returns are audited each year. This combination of the audit lottery and the absence of effective penalties makes it profitable for some taxpayers to reduce their tax liability through aggressive positions on their returns which masquerade as good-faith constructions of the tax laws. Revision of the penalty structure is, thus, clearly in order.

S. 2198 would impose an audit lottery penalty equal to 10 percent of an understatement of tax liability if the understatement is substantial, and it defines "substantial understatement" as one that is 10 percent of tax liability, but at least $5,000 in the case of an individual and $10,000 in the case of corporations.

We applaud the sponsors of S. 2198 for squarely facing the difficult issue of overly aggressive returns filed by taxpayers attempting to take advantage of the perceived weaknesses in our voluntary compliance system. There are, however, certain aspects of this penalty that we would think need further consideration.

One is whether adequate disclosure has been set forth in a tax return. That may be a very difficult question to resolve in particular cases, and we would like the opportunity to look at that question further.

Also, we wonder if the application of the penalty without exception might be inequitable in certain circumstances such as the case of an ill-informed taxpayer. We would like to work with the committee to fashion a penalty that would avoid or minimize these difficulties.

The second penalty measure of S. 2198 relates to the corporate officer or agent penalty for knowing participation in the tax fraud of a corporation. Knowing participation would include direct participation in the fraud by the individual, ordering a subordinate to participate in the fraud, or knowing of and not attempting to prevent participation in the fraud by a subordinate. However, conduct would constitute knowing participation only if the individual knew or should have known that participation would result in an underpayment of tax.

The unavailability of civil sanctions against corporate officers for participating in the fraud of a corporation leaves the IRS without an effective civil remedy against corporate officers who engage in conduct constituting tax fraud of a corporation. Therefore, we think this proposed change is in order.

We do wish the committee would consider a couple of further points on this penalty, however. First, we think the overlap of the return preparer penalty and the corporate officer agent penalty should be clarified; and, second, we raise the question of whether the $100,000 cap on the penalty might be too high in some circumstances, particularly in the case of relatively low-level employees. But, aside from these relatively small points on the proposed change, we think this penalty provision is sound and is well conceived.

The bill would also provide a series of revisions to the penalty provisions relating to information reporting and would add a withholding requirement in the situation where no social security number or other taxpayer identification number is provided to a payer, or where an incorrect taxpayer identification number is provided to a payer after the IRS has notified the payer that the number is incorrect.

Persons should not be able to disregard or deliberately avoid information reporting responsibilities with the expectation that a failure to report income will provoke, at most, trivial sanctions. We think significant penalties are appropriate where parties knowingly attempt to subvert the reporting requirements that are crucial to the functioning of our tax system.

Also, by implementing a system of source withholding on persons who are not willing to provide taxpayer identification numbers, S. 2198 would place the onus of correct information reporting on the person best able to insure that reporting is accurate. We think these changes as proposed are, therefore, appropriate and desirable.

S. 2198 would also impose a minimum penalty for extended failure to file a tax return. Under present law, the penalty for failure to file is based only on the amount of tax due. Thus, where no tax is due, no civil penalty is imposed. S. 2198 would impose a minimum late filing penalty of $100 when a return is filed late, more than 60 days after the due date of the return.

We have a couple of reservations about this proposed change, Mr. Chairman. First, we are somewhat worried about codifying a 60-day rule which would in effect allow returns to be filed 60 days late without any penalty, but where no tax is due. And we are also concerned about the applicability of the penalty possibly giving rise to a perception of Government insensitivity in certain cases where the penalty might be applied to poorly informed persons, although we would think a liberal construction by the IRS of the reasonable cause abatement exception would go far to allaying these concerns.

S. 2198 also provides a number of adjustments to the Internal Revenue Code interest computation provisions. These would apply both to interest due the IRS as well as interest due taxpayers. In our view, these changes are appropriate and welcome.

At present, under the Internal Revenue Code, interest is computed on a simple rather than a compound basis, and in the case of an underpayment or overpayment that is outstanding for several years, the simple interest computation has the effect of greatly understating the amount of interest due. For example, 15 percent simple interest for 5 years is equivalent to only 11.5 percent interest compounded semiannually. Thus, for debts outstanding for longer periods, simple interest even at a high rate does not provide adequate compensation for the use of money. The absence of a compound interest rate in the Code discourages prompt settlement of disputes and prompt payment.

S. 2198 would require interest to be compounded semiannually. This is a change that is long overdue. The only possible change in this proposal that we think the committee might consider is for debts that are of shorter duration, perhaps 1 or 2 years. In the case of taxpayers who try to compute their own interest on deficiencies, compounding would make it difficult, and the committee might consider whether it would be appropriate to use simple interest on taxes overdue short periods of time.

Dealing with the interest rate adjustments, under present law the interest rate applicable to tax deficiencies and overpayments is adjusted each January 1, effective for the ensuing calendar year, equal to 100 percent of the average prime rate during September of the preceding year. S. 2198 would provide for semiannual adjustment to the interest rate based on the average prime rate charged by banks during the 6-month period ending 3 months prior to the date of change. So, we would have a semiannual adjustment in the interest rate.

Regardless of the formula employed to fix interest rates during periods in which there are significant interest rate fluctuations, a possibility exists of significant differences between the interest rate determined under the formula and market interest rates. However, the proposed interest rate formula in S. 2198 would clearly yield an interest rate that more closely approaches a market rate than the formula provided under present law, and we think that is a good change.

Under present law, taxpayers who file a late return are able to earn interest on a refund from the due-date of the return if the IRS is not able to process the return within 45 days after receipt of the return. S. 2198 would change this result by providing that interest would be paid only from the date on which a return is filed if it is filed late. We think this is a desirable change.

In the same vein, S. 2198 provides that interest will be computed only from the date that a return is received by IRS in processable form. For a variety of reasons, the IRS receives returns which it cannot process through its systems because of deficiencies in the information provided. We think it is appropriate that a return not be considered filed until it is received in a processable form.

And finally, in the area of interest, the bill would limit interest on refunds resulting from operating loss and capital loss carrybacks as well as tax credit carrybacks. Under present law, interest commences from the first day of the taxable year following the year in which the loss or credit giving rise to the carryback occurs. We understand that some taxpayers are seeking to take advantage of the current high interest rates by delaying filing of the appropriate claim for refund and thus earning interest on a tax refund in excess of that which they would be able to earn at a bank or other financial institution. S. 2198 would provide that interest on the overpayments resulting from such a claim would be computed from the date on which the claim for refund is filed rather than from the first day of the year following the year in which a claim arises.

We think the system should not create artificial incentives to defer filing a tax refund claim, but we have some concern about the effect of the rule proposed by S. 2198 in the case of taxpayers who are unable to file their returns and file a claim for refund that arises from the return. We would like to work with the committee to insure that there would not be inequitable application of this rule in some cases, although the point of the change is well taken.

In the case of retirement plan and annuity distributions, S. 2198 would impose reporting requirements on employers who maintain qualified pension, profit sharing, stock bonus, and annuity plans, and on administrators of such plans, and would extend the withholding system to total distributions and, on a voluntary basis, to periodic payments from qualified plans, individual retirement accounts, and commercial annuities. It would also reverse the thrust of the current withholding system for distributions by such plans by requiring that a recipient be subject to withholding unless he elects not to have withholding apply.

Subject to certain technical changes, we support these provisions of S. 2198.

Finally, Mr. Chairman, on effective dates, I have not in our prepared statement dealt in a systematic fashion with the effective date provisions of S. 2198, but I would point out that it appears that certain effective date provisions in the bill might cause hardship where new reporting requirements are imposed.

For example, the interest paid after December 31, 1981, on obligations of corporations issued in bearer form would be subject to reporting for the first time. It would be difficult to comply with this requirement in the time period imposed, and we think it would be appropriate to work with the committee and the staff of the committee to devise effective dates that adequately take into account the practical difficulties that could arise in implementing some of the bill's provisions.

Also, Mr. Chairman, I just want to mention the provision of S. 2198 dealing with OMB, or Office of Management and Budget, oversight. The administration is still considering the application of the Paperwork Reduction Act to Treasury and to IRS, and we respectfully request an opportunity to advise the committee of the administration's views on this subject at a later time.

Also, we are working on detailed revenue estimates on S. 2198, and we would like to supply those more detailed revenue estimates as a part of the record of these hearings. They should be completed within the next 3 weeks.

[The information follows:]

The Budget Effect of the Taxpayer Compliance Improvement Act of 1982 (S. 2198)

($000,000)

| | 1983 Fully effective | Fiscal Years 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|
| **Receipts:** | | | | | | | |
| Charge tip information reporting ................ | 196 | — | 51 | 151 | 211 | 253 | 277 |
| Federal obligations and corporate bearer-bond information reporting ... | 873 | — | 127 | 443 | 700 | 1,015 | 1,320 |
| Securities and commodities information reporting ... | 255 | — | 18 | 100 | 184 | 283 | 345 |
| State income tax refund information reporting ... | 273 | — | 65 | 174 | 273 | 358 | 393 |
| Optional withholding on pensions ................. | 1,495 | — | 1,151 | 1,246 | 1,663 | 2,101 | 2,349 |
| Withholding on lump sum distributions ........... | 43 | — | 87 | 50 | 54 | 60 | 67 |
| Withholding of tax on certain "qualified payees" ................ | 32 | — | — | 3 | 16 | 28 | 40 |
| Payor/payee penalties for failure to comply with information return requirements ............ | 251 | — | 33 | 156 | 282 | 334 | 367 |
| Substantial underreporting penalty ................. | 213 | — | 110 | 200 | 257 | 265 | 267 |
| Subtotal, receipts .... | 3,628 | -- | 1,642 | 2,523 | 3,640 | 4,697 | 5,425 |
| **Interest and penalties:** | | | | | | | |
| Interest compounded semiannually ............ | 316 | — | — | 99 | 201 | 168 | 128 |
| Revised interest rate determination ........... | -27 | — | -23 | -44 | -61 | -93 | -94 |
| Interest on delinquent returns ................. | 41 | — | 41 | 40 | 37 | 34 | 30 |
| Interest on unprocessable returns ................. | 16 | — | 16 | 16 | 15 | 14 | 12 |
| NOL carryback interest limitation ............... | 499 | — | 446 | 437 | 400 | 369 | 323 |
| Corporate officers and others fraud penalty .... | 5 | — | 5 | 5 | 6 | 6 | 6 |
| Relief from criminal penalty for underpayment of estimated tax where statutory exceptions are applicable...... | — | — | — | — | — | — | — |
| Payor/payee penalties for failure to comply with information return requirements ............ | * | — | — | — | 11 | 4 | * |
| Substantial underreporting penalty ................. | 284 | — | — | 242 | 296 | 347 | 362 |
| Minimum penalty for extended failure to file 1/ | 64 | — | 26 | 67 | 56 | 48 | 37 |
| Subtotal, interest and penalties .......... | 1,198 | -- | 511 | 872 | 961 | 897 | 804 |
| Grand total .......... | 4,826 | -- | 2,153 | 3,395 | 4,601 | 5,594 | 6,229 |

Office of the Secretary of the Treasury, Office of Tax Analysis May 7, 1982

1/ Includes a speed up of receipts due to the decrease in untimely filed returns.

*Less than $500,000.

Mr. CHAPOTON. Thank you, Mr. Chairman.
[The prepared statement follows:]

For Release Upon Delivery
Expected at 10:00 a.m.
March 22, 1982

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
OF THE INTERNAL REVENUE SERVICE
COMMITTEE ON FINANCE

Mr. Chairman and Members of this Committee:

I am pleased to be here today to discuss the provisions of S. 2198, the "Taxpayer Compliance Improvement Act of 1982." In general, we view this bill as an important step in reducing the compliance tax gap -- which Commissioner Egger has just described.

Overview

This is a particularly appropriate time to consider steps that might be taken to collect taxes due under existing law which, for a variety of reasons, currently escape collection. I would like to compliment the Chairman and this Committee for holding hearings on the issues presented by the tax gap. I would also like to thank the Chairman and other sponsors of S. 2198 for introducing this measure, which we think takes important steps toward reducing the compliance tax gap as well as preserving the integrity of our voluntary tax compliance system.

The provisions of S. 2198 may be divided into five categories: (1) broadening the scope of and improving the quality of information reporting; (2) reworking the penalty structure of the Internal Revenue Code to correct certain deficiencies, and to deter troublesome and growing abuses that may reflect increasing public acceptance of noncompliance; (3) adjusting the method of computing interest on payments and receipts by the IRS; (4) revising the antiquated rules dealing with voluntary withholding of tax on retirement plan distributions; and (5) ancillary issues, chiefly application of the Paperwork Reduction Act of 1980 to Treasury and IRS. I will discuss each of these provisions in turn.

Reporting Requirements

General

Under existing law, many types of payments are subject to information reporting. Most payments of dividends and interest aggregating more than $10 in a year are required to be reported to the IRS on Form 1099. Copies of Form 1099 are also required to be sent to taxpayers so that they will have the amount of income from each source readily available. The chief class of obligations that is not covered by these reporting rules is obligations of the United States Government (although there is reporting by the Bureau of the Public Debt to IRS on some types of obligations). Payments such as royalties, rents and annuities are subject to information reporting if the payor is engaged in a trade or business, and the payments in a year exceed $600.

Wages paid to individuals are subject to information reporting in addition to withholding of tax at source. The wage withholding system has been in place for almost forty years; the system has long been accepted, and it is generally agreed that the system functions well.

S. 2198 would effect major changes to the tax rules governing information reporting. The thrust of these provisions is to increase the number of transactions subject to information reporting and, in conjunction with certain proposed penalty provisions, to improve the quality and usability of reported information. We recognize that information reporting on taxable transactions is valuable both to the Government -- to enable it to check the information reported by taxpayers -- and to the vast majority of taxpayers who conscientiously attempt to report all of their income. Time and experience have shown, however, that information reporting is not a panacea: We need only contrast the rate of taxpayer compliance in the wage area, where withholding is generally required, with current levels of compliance in areas where only information reporting is required. It is estimated that wage and salary income, most of which is subject to withholding, is underreported by only 2 or 3 percent; on the other hand, the comparable figure for interest and dividend income, most of which is subject to information reporting only, is between 10 and 16 percent. Twenty billion dollars or more each year in interest and dividend income goes unreported.

There is little question that compliance is substantially higher under a withholding system than under a system of information reporting only. We therefore believe the time has come for imposing withholding on interest and dividend income as long as the costs to withholding agents of implementing this system are not excessive. For that reason, the Administration has proposed withholding on interest and dividends. Thus, while improving and extending the information reporting network is desirable, particularly to the extent that U.S. Government and corporate bearer obligations would become subject to reporting, we believe that the tax gap has grown too large for us to continue to take limited incremental steps toward improved taxpayer compliance in the interest and dividend area.

The balance of the bill's provisions broadening the scope of information reporting call for: (1) reporting on charged tips; (2) reporting by State and local governments on tax refunds; and (3) issuance of regulations requiring reporting by commodities and securities brokers. Let me discuss these proposals in turn.

Charged Tips

Employees who receive tips of $20 or more in a month are required under present law to report such tips to their employer. The employer, in turn, is required to report to the IRS (and to the employee) the amount of tips reported by the employee. The employer is similarly obligated to withhold tax on tips reported by the employee.

Tips are clearly compensation and thus constitute taxable income. Current estimates show that employees report less than 20 percent of their tip income. This is simply unsatisfactory taxpayer compliance. S. 2198 would require employers to treat tips that are charged on a credit card, and paid over by the employer to an employee, as wages subject to information reporting. Small employers, who are defined as those who normally had five or fewer employees during the preceding calendar year, would be exempt from this reporting requirement. Since a paper record is already generated by the credit card transaction, there should be little additional paperwork burden as a result of this requirement; it is therefore desirable to impose information reporting in these circumstances.

State Tax Refunds

Taxpayers are required to include in income the amount of any State or local income tax refund, if the tax was deducted in a prior year, and the deduction gave rise to a tax benefit. Frequently, however, taxpayers fail to include these refunds in income. Doubtless this noncompliance sometimes results from taxpayer ignorance of the requirements of substantive law. In addition, we believe that taxpayers often completely overlook the fact that they received a refund in the prior year, or lack the particulars about the refund when they fill out their income tax returns. S. 2198 would go far to remedy both of these problems. Receipt of information reports from the States and local taxing jurisdictions would heighten taxpayers' awareness that the refunds are taxable. Additionally, the requirement would provide taxpayers with a timely paper record of the information which they require.

Although this provision is clearly desirable from the point of view of Federal tax administration, we must tread carefully in imposing a requirement of even this limited nature on State and local governments, if for no other reason than out of concern for the costs to the States of complying with these new reporting requirements. We note, however, that there has been a proliferation of information exchange agreements between the Federal and State governments. It is anticipated that many States would satisfy their obligations under this provision of S. 2198 by simply providing the information called for by current agreements (although information would also be required to be provided to the individual taxpayer, a practice that is not now in effect). It thus appears that it would not be unduly burdensome to ask the States and local governments to take the further step of insuring that taxpayers have the needed records concerning State tax refunds to complete their Federal tax returns.

Reports by Securities and Commodities Brokers

The tax law has long provided the Internal Revenue Service with authority to require reporting by brokers of the profits and losses and other information concerning their customers. At present, there are no such requirements in effect. S. 2198 would mandate the issuance of regulations requiring information reporting by commodities and securities brokers on capital transactions, as well as the sale or transfer before maturity of any bond or other evidence of indebtedness (other than Treasury Bills or commercial paper sold or transferred by corporations). In its present form, S. 2198 would require that this information be reported only to the IRS, not to the taxpayers involved. In our view, a substantial part of the value of reporting lies in the fact that it informs taxpayers of their taxable income -- in this case, gains and losses on securities and commodities transactions. The failure of taxpayers to receive this information could well account for the very high rate of noncompliance -- 56 percent -- for capital transactions generally. If reporting of capital transactions is to be mandated, we hope the Committee will give careful consideration to the desirability of furnishing information to taxpayers as well as the IRS.

In cases where a brokerage house does not possess all of the information necessary for the taxpayer to compute gain or loss on a given item, we would anticipate that regulations would simply require that the brokerage house report the information that it has. For example, in the case of a customer who brings a security to a brokerage house for sale, the brokerage house would report the sale proceeds. While this would not provide full information on the amount of gain or loss from this transaction, it would give the IRS sufficient information to determine that the full proceeds were correctly reported, and would fully inform the taxpayer of the sale transaction, requiring only that he ascertain his tax basis to report the transaction correctly.

The extremely poor rate of compliance for capital transactions generally leads us to the conclusion that information reporting by securities and commodities brokers is desirable. However, we would like an opportunity to consider certain questions that are raised by this provision. First, we would wish to consider the types of information that would be useful to IRS in improving compliance in this area. Second, we would like to examine the costs both to the brokerage industry and to the IRS of producing information that would be useful to the Government and taxpayers. We look forward to working with you and representatives of the brokerage industry to develop answers to these questions.

Reporting In Machine-Processable Form

S. 2198 would permit the Commissioner to require that tax returns be filed in a machine-processable form, including on magnetic media in the case of a person who is required to file multiple returns. It is substantially simpler and cheaper for the IRS to process documents filed in machine processable form. Many persons filing large numbers of returns now voluntarily report in magnetic form. Reporting on magnetic media is typically no more expensive (and often less expensive) than reporting on paper. At a time when businesses are increasingly relying on computers to perform basic information processing functions, it seems appropriate to confirm that the Commissioner may require reporting in this manner, recognizing that it will be necessary to employ a flexible approach to take into account situations where persons do not have computer capability.

Penalty Provisions

Penalties in a voluntary tax compliance system must have two basic characteristics. First, the penalties must deter taxpayer behavior that would impair the voluntary tax compliance system; persons who purposely or recklessly fail to comply with the tax law must be subject to sanctions. Second, penalties must take into account, through abatement processes or otherwise, reasonable errors or omissions made in good faith. This second element is particularly important given the degree of complexity of our tax laws.

Although most taxpayers wish to pay their fair share of taxes, there is an institutionalized minority that relies on flaws in the existing penalty structure to avoid taxes. This avoidance results, in part, from the opportunity under current rules to take highly questionable or aggressive positions on tax returns with knowledge that even if the position taken is struck down, no penalty will be imposed on the resulting tax deficiency so long as a "reasonable basis" for the position taken exists. Because only a small percentage of returns are audited each year, these aggressive positions may never be scrutinized or questioned by the Internal Revenue Service (although it is true that IRS audits a relatively high percentage of certain returns based on selection techniques indicating a high probability of a substantial audit adjustment). Thus, the combination of the audit lottery and the absence of effective penalties makes it profitable for taxpayers to reduce their tax liability through aggressive positions on their tax returns which masquerade as good faith constructions of the tax law. Revision of the penalty structure is thus clearly in order.

Some progress has been made in dealing with abusive taxpayer behavior of this sort. An over-valuation penalty was added by the Economic Recovery Tax Act of 1981 to deter taxpayers from claiming exaggerated deductions or credits based on an overstated valuation of property. As structured, the penalty will apply if the claimed value of property exceeds 150 percent of its true value; appraisal reports or opinions of experts will not, in general, prevent application of the penalty.

Audit Lottery Penalty

S. 2198 would impose an "audit lottery" penalty equal to 10 percent of an understatement of tax liability if the understatement is substantial. A substantial understatement is defined as 10 percent of tax liability, but at least $5,000 for individuals, subchapter S corporations and personal holding companies, and $10,000 for other corporations. In computing the understatement, items giving rise to a deficiency would be treated as having been reported properly and full tax paid thereon if the taxpayer adequately disclosed on the return or an attachment to the return that the reporting of the item was questionable. Thus, taxpayers who are uncertain about the resolution of an issue may continue to take "reasonable basis" positions, just as under existing law. Taxpayers would, however, be required to disclose to IRS the fact that the questionable or aggressive position has been taken or else face the possibility that this penalty would be imposed.

I applaud the sponsors of S. 2198 for squarely facing the difficult issue of overly aggressive returns filed by taxpayers attempting to take advantage of perceived weaknesses in our voluntary compliance system. It is important to reverse the perception among some taxpayers that adopting aggressive tax return positions is necessary or appropriate to avoid "overpaying" taxes relative to other taxpayers. The audit lottery penalty would undoubtedly go far in reducing that perception.

There are certain aspects of this penalty that we believe are in need of careful consideration. Whether adequate disclosure has been set forth in a tax return may be difficult to resolve in certain cases. Also, we wonder if

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application of the penalty might be inequitable in cetain circumstances, such as in the case of ill-informed taxpayers. We would like to work with this Committee to fashion a penalty that would avoid or minimize these difficulties.

Corporate Officer/Agent Fraud Penalty

The second penalty measure of S. 2198 that I wish to review in detail is the corporate officer/agent penalty for participation in the tax fraud of a corporation. Under this provision, a corporate officer, director, or employee, as well as a corporate agent, would be liable for a civil penalty equal to 50 percent of an underpayment of tax by a corporation if the corporate officer or agent "knowingly participated" in the fraud. Knowing participation would include direct participation in the fraud by the individual, ordering a subordinate (whether or not the subordinate was employed by the corporation) to participate in the fraud, or knowing of and not attempting to prevent participation in the fraud by a subordinate. However, conduct would constitute "knowing participation" only if the individual knew or should have known that the participation would result in an underpayment of tax.

Under present law, corporate officers are subject to criminal penalties but not civil penalties for participating in the tax fraud of a corporation. Agents who are tax return preparers may be subject to civil liability of $500 for participating in such fraud. The unavailability of civil sanctions against corporate officers for participating in the fraud of a corporation leaves the IRS without an effective civil remedy against corporate officers who engage in conduct constituting tax fraud of a corporation. While a civil fraud penalty may be asserted against the corporation itself, the burden of such a penalty is borne by the shareholders; particularly in the context of a publicly held corporation, the corporate officer might not feel the "sting" of that penalty.

Initially, the issue of the overlap of the return preparer penalties and the corporate officer/agent penalty should be clarified. Presumably, the amount of any corporate officer/agent fraud penalty should be reduced by the amount of any return preparer penalty. Second, we wonder whether a penalty of $100,000, particularly in the case of relatively low-level employees, may be somewhat high. Aside from these issues, however, the penalty is, in our view, soundly conceived. Conduct amounting to tax fraud committed by a person doing business in noncorporate form would give rise to a civil fraud penalty. It is difficult to see why a different result should obtain merely because the business is carried on in corporate form. Therefore, we view the concept of this penalty as a logical and necessary supplement to the Code provisions dealing with tax fraud.

<u>Penalties for Failure to File Returns or Provide Taxpayer Identification Number</u>

The bill provides for a series of revisions to the penalty provisions relating to information reporting, and adds a withholding requirement in the situation where no social security number or other taxpayer identification number is provided to a payor, or where an incorrect taxpayer identification number is provided to a payor, after the IRS has notified the payor that the number is incorrect. Briefly, these provisions are as follows:

- Where a person fails (1) to furnish a taxpayer identification number to a payor, (2) to include a taxpayer identification number in a return, or (3) to include the taxpayer identification number of another person in a statement or return filed (<u>e.g.</u>, A's failure to include B's social security number on a Form 1099 issued to B), the $5 penalty provided under present law would be increased to $50, with a maximum of $50,000 (increased from $25,000) for all such failures during a calendar year. Where the failure to include another person's taxpayer identification number in a return filed is intentional, the penalty would be $100 per failure, with no limit.

- Where a payor fails to file an information return on dividends, interest or other amounts, the penalty would be increased from $10 to $50 per failure, but not to exceed $50,000 (increased from $25,000). If the failure to file such returns is due to intentional disregard of the filing requirements, the penalty would be 10 percent of the amount of the payment (5 percent in the case of reports by brokers).

- If a payee fails to provide a taxpayer identification number to a payor, withholding at the rate of 15 percent would be required. Alternatively, if IRS determines that the taxpayer identification number provided to the payor is incorrect, the payor would start withholding upon notice from the IRS that the taxpayer has failed to supply the correct taxpayer identification number. Withholding would continue as long as the taxpayer fails to provide a number, or does not correct an incorrect number.

Persons should not be able to disregard or deliberately avoid information reporting responsibilities with the expectation that a failure to report income will provoke, at most, trivial sanctions. S. 2198 goes far to making the various Code reporting requirements meaningful by generally increasing the penalties for refusals to comply. I would like to comment on two of these penalty provisions.

The minimum penalty of 10 percent of the amount subject to the reporting requirement (5 percent in the case of reports by brokers) where a payor intentionally disregards the filing requirements would in some cases result in a substantial penalty. However, we think significant penalties are appropriate where parties knowingly attempt to subvert the reporting requirements that are crucial to the functioning of our tax system.

Next, let me mention the "penalty withholding" provision. Many information reports which are received either lack a taxpayer identification number altogether, or show an incorrect number. Fully 11 percent of the reports on dividends and interest payments lack this information. These defective reports are in many cases worthless to the Internal Revenue Service; those reports that are corrected are done at very substantial expense. By implementing a system of source withholding on persons who are not willing to provide correct taxpayer identification numbers, this provision will place the onus of correct information reporting on the person best able to insure that the reporting is accurate.
We think this is an appropriate and desirable sanction.

Minimum Penalty for Extended Failure to File

Under present law, a person who fails to file a tax return on a timely basis is subject to penalties based on a percentage of the amount of tax due. Thus, where no tax is due, no civil penalty can be assessed. In many cases, IRS finds it necessary to seek out persons who have failed to file their tax returns, in order to obtain such persons' returns. Many of these persons ultimately are entitled to refunds. In those cases, IRS' efforts to compel the filing are not recompensed, except for the value of the right to use the refund without interest expense (assuming IRS pays the refund within 45 days after the return is filed). S. 2198 addresses this problem by imposing a minimum late filing penalty of $100 when a return is filed more than 60 days after the return due date (including extensions).

We have two reservations about this provision. Initially, we are concerned about the effect of codifying a rule allowing late filing by 60 days. Although we recognize that there could be substantial practical problems in applying this penalty without a grace period, we are not persuaded that Code-sanctioned late filing is a desirable rule of law.

Second, we are concerned that application of the penalty could give rise to a perception of government insensitivity in certain cases where a penalty was applied to poorly-informed persons; however, a liberal construction by IRS of the "reasonable cause" exception to the penalty would go far toward allaying those concens.

Relief From Criminal Penalty for Failure to File Estimated Tax Return Where Exceptions Applicable

Under present law, the obligation to file an estimated tax return, and the criminal sanction for failure to file such a return, are not correlated with the exceptions to the penalty for underpayment of estimated tax liability. Thus, a sanction for failure to file an estimated tax return may exist for a person who would incur no penalty for underpayment of estimated taxes because one of the statutory exceptions is applicable. S. 2198 would conform the rules imposing criminal liability for failure to file a return to the exceptions from liability for underpayment of estimated taxes. We support this provision.

Interest Computation Method

S. 2198 provides a number of adjustments to the Internal Revenue Code interest computation provisions, which apply both to interest due to IRS as well as interest due to taxpayers. In our view, these changes are appropriate and welcome.

Compounding of Interest

At present, interest under the Internal Revenue Code is computed on a simple rather than a compound basis.

Particularly in the case of an underpayment or overpayment that is outstanding for several years, the simple interest computation has the effect of greatly understating the amount of interest due.

For example, 15 percent simple interest for 1 year is equivalent to 14.5 percent interest compounded semi-annually -- not a significant difference. However, 15 percent simple interest for 5 years is equivalent to only 11.5 percent interest compounded semi-annually. For 10 years, a compounded rate of 9.4 percent is equivalent to 15 percent simple interest. Thus, for debts outstanding for longer periods, simple interest -- even at a high rate -- does not provide adequate compensation for the use of money. As a result, the absence of a compound interest rate in the Code discourages prompt settlement of disputes and prompt payment.

S. 2198 would require interest to be compounded semi-annually. This would bring the tax interest computation into line with modern commercial practice, and would insure that both taxpayers and the Government are treated fairly when they are in a position to receive interest payments. This is a change that is long overdue. We do wish to point out, however, that taxpayers who compute their own interest on deficiencies could have some difficulty in doing so when a compound rate is employed. We would like the opportunity to further consider wheather it would be appropriate to use simple interest, rather than a compound interest computation, for deficiencies that are outstanding for a relatively short period of time.

Interest Rate Adjustments

Under present law, the interest rate applicable to tax deficiencies and overpayments is adjusted each January 1 effective for the ensuing calendar year to a rate equal to 100 percent of the average prime rate in effect during September of the preceeding year, rounded to the nearest full percentage. This rule was adopted as part of the Economic Recovery Tax Act of 1981. Prior to the 1981 Act, the rate was adjusted every two years, based on a rate equal to 90 percent of the prime interest rate.

S. 2198 would provide for semi-annual adjustments to the interest rate, based on the average prime rate charged by banks (rounded to the nearest full percentage) during the six-month period ending three months prior to the date of the change.

I think it is important that we not let our basic concerns about high interest rates, and large fluctuations in interest rates, affect our analysis of the proper interest rate to be charged on tax overpayments and deficiencies. Regardless of the formula employed to fix interest rates, during periods when there are significant interest rate fluctuations, the possibility of significant differences between the interest rate determined under the formula and a market interest rate will exist. Under many circumstances, however, the proposed interest formula will yield an interest rate that more closely approaches a market rate than the formula provided under present law.

Restrictions on Payment of Interest

In a study by the General Accounting Office, it was pointed out that taxpayers who file a late return are able to earn interest on a refund from the due date of the return if the IRS is not able to process the return within 45 days after receipt. The GAO perceived this to be a potential abuse, and we agree. S. 2198 would change this result by providing that interest would be paid only from the date on which a tax return is filed, if it is filed late. Although interest is compensation for the use of money over time, the principle that interest should not generally be paid on a refund is presently established in the tax law -- no interest is due unless IRS fails to pay the required refund within 45 days of the date that the return is filed. The proposed change would not diminish the Service's incentive to issue refunds promptly; it would merely deny a windfall benefit to taxpayers who might deliberately delay filing their return, hoping that the IRS will miss the 45 day deadline. We think, therefore, that this is a desirable change.

In the same vein, S. 2198 provides that interest will be computed only from the date that a return is received by IRS in "processable" form. For a variety of reasons IRS unfortunately receives a number of returns each year which it cannot process through its system. Although IRS prefers to work with taxpayers to rectify filing deficiencies, it is not equitable for IRS to be burdened with the obligation of dealing with such a return within the 45-day period. Therefore, it is appropriate to limit the IRS' obligation to pay interest on overpayments after 45 days following filing of a return so that the return is not be considered filed until it is received in a processable form.

Finally, the bill would limit interest on refunds resulting from operating loss and capital loss carrybacks as well as tax credit carrybacks. Under present law, interest on a refund resulting from such a carryback is computed commencing with the first day of the taxable year following the year in which the loss or credit giving rise to the carryback occurs. We understand that some taxpayers might seek to take advantage of this rule, particularly in the context of the current high interest rates applicable to overpayments, to delay filing a refund claim, thereby earning interest on the tax refund in excess of what they might earn at a bank or other financial institution. S. 2198 would provide that interest on an overpayment resulting from such a carryback would be computed from the date on which a claim for refund is filed, except that interest accruing prior to March 12, 1982 would not be affected.

Although we think the tax system should not create artificial incentives to defer filing of a tax refund claim, some persons have asserted that the rule proposed by S. 2198 would unduly restrict the payment of interest to taxpayers who are unable to file their returns, and, therefore, their refund claims, prior to the due date of the return for the loss or credit year. Therefore, we would like to work with this Committee to insure that there would not be inequitable application of this rule in some cases.

## Withholding on Retirement Plan and Annuity Distributions

S. 2198 would impose reporting requirements on employers who maintain qualified pension, profit-sharing, stock bonus and annuity plans and on administrators of such plans; would extend the withholding system to total distributions, and, on a voluntary basis, to periodic payments from qualified retirement plans, individual retirement accounts and commercial annuities; and would reverse the thrust of the current withholding system for distributions by such plans by requiring that a recipient be subject to withholding unless he elects not to have withholding apply. Subject to certain technical changes, we support these provisions of S. 2198.

### Current Law

The basic principle that underlies the taxation of distributions from qualified retirement plans or commercial annuities is a familiar one: Distributions that exceed the recipient's basis are generally includible in income in the year received. However, the rules for determining the recipient's basis are often complex, and significant exceptions to the general rule exist. As a result, taxpayers often do not understand the extent to which distributions constitute taxable income. The problem is compounded by the current withholding system and exacerbated by inadequate reporting requirements.

Under current law, there is no mandatory or voluntary withholding on total or lump sum distributions. Thus, the recipient of such a distribution may find it necessary either to increase wage withholding or to make estimated tax payments in order to avoid a penalty for underpayment of estimated taxes. In the case of periodic pension or annuity payments, withholding is possible, but only if it is requested by the recipient. Thus the current withholding system is partial, voluntary, and requires an affirmative act by the recipient.

In addition, the present information reporting system is not effective in providing taxpayers and the Internal Revenue Service with the information required to determine tax liability.

<u>Reporting</u>

The pension and annuity reporting requirements contained in S. 2198 would constitute important steps in closing the compliance gap. Under current law, a person who makes pension or annuity payments in excess of $600 or more in a taxable year must report such payments in accordance with Treasury regulations. Lump sum distributions from pension plans and commercial annuities are reported on Form 1099R while Form W-2P is used in the case of periodic payments. These forms are designed to provide taxpayers and the Internal Revenue Service with the information needed to calculate the individual's income tax liability. However, in many cases, the party making the payment has no access to the required information. For example, in order to compute the capital gains portion of the recipient's distribution, it is necessary to know when the recipient's plan participation began and when it ended. In most cases, that information is in the possession of the plan administrator, rather than the bank trustee or insurance company making the payments. While employers and plan administrators generally provide recipients with the required information, there is no statutory obligation that they do so. Under S. 2198, plan administrators would be required to provide both the recipients of distributions and the Internal Revenue Service with the information needed to determine income tax liability. We believe it is imperative that such an obligation be imposed on plan administrators, and we therefore support this portion of S. 2198.

Withholding on Periodic Payments

S. 2198 would also institute a new system of voluntary withholding on periodic benefit payments under qualified plans or commercial annuities. These provisions would apply to typical pension or annuity payments that are made for a specific number of years or over the recipient's lifetime. The taxable portion of these payments, which is the amount attributable to employer contributions, would be subject to withholding as if it were wages.

The withholding system on periodic payments would be voluntary; the recipient could elect on an annual basis not to have withholding apply. Payors would be required to notify recipients of the opportunity to elect out of the withholding system.

We support these measures to make it easier for pension recipients to use withholding and to avoid the obligation to make estimated tax payments and unanticipated tax burdens at the end of the year. However, we have some concern that the notice provisions of the bill may impose undue burdens on plan administrators. We would be happy to work with this Committee to insure that these provisions pose the minimum administrative burden consistent with informing pension recipients of their right not to have withholding apply.

Withholding on Total Distributions

S. 2198 would also impose withholding on the taxable portion of a "total distribution." A total distribution is a distribution within one taxable year to the recipient of the balance to his credit under an eligible retirement plan or commercial annuity. As with periodic payments, only the taxable portion of the distribution would be subject to withholding. However, unlike withholding on periodic distributions, withholding on total distributions would be mandatory unless the recipient notified the payor that the distribution would be rolled over to an individual retirement account (IRA) or a qualified plan. Further, withholding would be calculated on the basis of the ten-year averaging rules of section 402(e) of the Code. This will generally result in lower withholding than if normal wage withholding tables and computational procedures were used.

We generally support the withholding system that would apply to total distributions. Specifically, we agree that it is appropriate to institute withholding on these payments; we believe that an exception for rollovers must be made; and we believe that use of the ten-year forward averaging rates on total distributions is an appropriate way to minimize overwithholding.

Other Provisions

Issuance of Regulations

Under S. 2198, the Internal Revenue Code would be amended to require that rules and regulations necessitated by future Code amendments be issued "as soon as possible." I am not certain of the purpose for this provision. I have no hesitancy in saying that Treasury and IRS today issue all regulations "as soon as possible." Continual changes in the law, the need to carefully consider technical and policy issues presented in the interpretation of complex statutory provisions, and the need to carefully consider the views of affected taxpayers, all delay the issuance of regulations. While I share the general concern about the backlog of regulations projects, I am uncertain about the desirability of writing this measure into the public law.

Effective Dates

I have not in this statement attempted to systematically comment on the effective date of each of the many provisions of S. 2198. I do wish to note, however, that it appears to us that early effective dates for certain of the provisions -- particularly, for example, where new reporting requirements are involved -- could create hardships for persons required to comply with the requirements, as well as for the Internal Revenue Service, in preparing to comply with these measures. Just as an example, I note that interest paid after December 31, 1981 on obligations of corporations issued in bearer form would be subject to reporting for the first time. Obviously, it would be difficult to comply with this requirement in many cases.

We would be happy to work with the Committee in devising effective dates for these provisions which adequately take into account practical difficulties which could arise in implementing some of the bill's provisions.

OMB Oversight

The last provision of S. 2198 that I would like to mention is section 202(b), which would eliminate oversight by the Office of Management and Budget over certain Treasury functions, particularly those discharged by IRS, under the Paperwork Reduction Act of 1980.

The Administration is still considering the application of the Paperwork Reduction Act to Treasury and IRS, and respectfully requests an opportunity to advise the Committee of its views at a later time.

Revenue Estimates

The Office of Tax Analysis in the Treasury is currently in the process of estimating the revenue effects of the bill's provisions. These estimates are expected to be completed within the next three weeks. We will furnish these estimates for the record as soon as they are available.

Senator GRASSLEY. Thank you, Secretary Chapoton and Commissioner Egger, for your testimony. We will follow up with you, as you suggested, in those areas where you haven't submitted a firm statement on certain sections of the legislation.

I will call on Senator Dole for questioning first and then Senator Baucus, and then I have some questions I want to ask.

Senator Dole.

Senator DOLE. First, I wish to thank the Commissioner, Mr. Egger, and Mr. Owens and others, as well as Mr. Chapoton and the Treasury for their cooperation, because this has been a long process. I know you have been working on it for a number of months, and we believe it is an area that we should address. I think it is very timely, because April 15 is rolling around, and I would hope there would be at least some notice to taxpayers who hadn't planned on reporting any income this year that it might not be a bad idea to do so. Maybe we could pick up a few extra dollars between now and April 15. And I think you did indicate when the effective date for most of these provisions should be.

How quickly can we implement this if the Congress would pass it, say by June 1?

Commissioner EGGER. I think it will differ with the different items. Some of these information reporting provisions in here, Senator Dole, will have to probably go over, past fiscal year 1983, simply because of the necessity not only to get the mechanism in place by the payers but to allow us to gear our systems up to be able to deal with the information in appropriate fashion.

We would be glad to work with the staff here in trying to analyze each of the particular provisions.

Senator DOLE. But it is my understanding that, rather than to proceed withholding immediately—even though that might be enough to make up our deficit—you prefer to try the information route for most types of income. Is that correct? I know Treasury has a different view on interest and dividend income.

Commissioner EGGER. I think our view and Treasury's view is identical, in the sense that withholding clearly will provide a more efficient way to produce the revenue. But, certainly the next best way is an adequate and effective information reporting program.

Senator DOLE. I assume that's how we will proceed. But it would seem to me that we are struggling, almost on a daily basis, looking for revenue and a way to go back to some taxpayers and say, "You should pay more," or we should "close certain loopholes." And we should. I don't suggest we shouldn't take action on the proposals that have been forwarded by the administration; at least on most of those I think we can take some action.

But, on the other hand, it would seem to me if that came to a vote in this committee, or anything that would increase taxes or let's say defer the third-year tax, why should we do that, if there are enough people out there not paying any tax and if we could pick up that revenue with immediate withholding?

It would seem to me that that choice would be fairly easy. If I were a taxpayer, and Members of Congress voted not to tax some people at all but to take away my tax cut scheduled for July 1, 1983—I am not suggesting that will happen, but that has been proposed by one or two people, at least—I think that would deserve a lot of consideration by this committee.

Commissioner EGGER. I did not mean to suggest that we would recommend deferring anything that didn't have to be deferred, simply in order to be able to gear up. I had reference primarily to areas such as the capital gains area, where the reporting problems there haven't been fully analyzed. That was the only reason for that comment.

Senator DOLE. But I think, as you indicated, that withholding has become a benefit to the taxpayer as far as wages are concerned and could be a benefit to anyone else.

Commissioner EGGER. Yes.

Senator DOLE. I know the brokers will complain. I understand they will submit a written statement.

I think my time has expired for the first round, but I wanted to ask Mr. Chapoton a question. I know you are not here primarily for the leasing question, but——[Laughter]

That's also been raised as an area where we might find some revenue, either by repeal or modification.

We have had a number of good witnesses who have taken a different view this week, who, of course, would benefit if we did nothing with leasing.

Now, as you know, we put in the black lung bill a number of provisions. One required reporting by January 31 so that Treasury would have a chance to see who was benefiting from the leasing provisions. Have you had enough time to complete a study of those who have reported?

Mr. CHAPOTON. Mr. Chairman, we are very nearly in a position to release that study. The information has been received, has been assimilated in a form that can be analyzed, and we will be completing our analysis of that and be releasing it some time presumably prior to the end of this month, which would be late this week or early next week.

Senator DOLE. Well, that would be very helpful. I think you are aware of the concern in Congress about this provision by, I would guess, a majority of members in both parties. And that information can be very useful as we try to find out how we are going to come to grips with what appears to be a provision that is much too generous.

So, if we could have it fairly soon; because it is my hope that we will complete all the hearings on the President's proposals, then maybe by the 31st of this month we would have some staff options presented. Then we would proceed to marking up what we can in this committee. We would hope to do that with all the information available.

Mr. CHAPOTON. I think the information will be available in time for that.

Senator GRASSLEY. Thank you, Senator Dole.

Senator Baucus.

Senator BAUCUS. Mr. Commissioner, earlier Secretary Chapoton had said that he had some potential minor, or maybe not so minor, problems with the 10-percent penalty provision, and I'm wondering if you agree with Mr. Chapoton in the thrust of the slight problems he had; that is, some innocent people might get caught. And he also had a small question about what constituted adequate disclosure. Do you agree with those reservations?

Commissioner EGGER. I certainly agree, but——

Senator BAUCUS. Or in working with the committee to try to solve those potential problems?

Commissioner EGGER. Right. We have taken a look at it to see whether on the first glance there would be any real risk of doing violence to small, lower-income taxpayers, and we don't see that happening. But there are other risks in it that we do want to look at, along with the Treasury and with the staff here.

Senator BAUCUS. A second question crossed my mind during the testimony of both of you this morning, and that is, the proposals in the bill that require securities brokers to supply information to the IRS. And the recommendation is that the same information be supplied to the taxpayer; but only the requirement that the broker supply the information that it now customarily furnishes to its customers.

What happens if the broker decides he is going to back off on the information that he gives to his customers? If, through one way or another, he gets outrageous complaints—and I say that advisedly—from customers about all these additional requirements, the broker changes his mind and somehow doesn't supply that same information, is that a worry, or is that not a worry?

Mr. CHAPOTON. I don't believe that would be a worry. I think the requirement could well be for them to supply the information they have. They certainly have the information on the sales proceeds from the transaction.

I think the main concern about that provision is that we need to simply look further at the cost of doing it and the ability of the IRS to use the information when it gets it.

Senator BAUCUS. One estimate I have of noncompliance for the compliance gap—this is prepared by the Joint Committee—is that by 1985 the compliance gap would be about $102 billion. And the Joint Committee further estimates that in the same year, 1985, that the reduction of that compliance gap will be only $92.7 billion if this bill that we are talking about is enacted and if the administration's enforcement proposals are enacted. That is not much of a reduction.

Do you agree with those figures, that there will only be about a $10 billion difference in the compliance gap for 1985 if this bill passes?

Mr. CHAPOTON. As I mentioned in my testimony, we are examining the details of the provision; but we are going to come out very close, I'm certain.

Senator BAUCUS. Well then, it seems to me we are wasting our time here. Sure, we should reduce the compliance gap, but what's the heart of the problem here? Why aren't we focusing more on that remaining $92 billion?

Mr. CHAPOTON. Well, Senator Baucus, it is a difficult problem. Just by the size of the noncompliance now, it shows you the magnitude of the problem. This bill would go a long way toward dealing with some of the major areas, but there is still noncompliance in one area that we are concerned about, and that is the independent contractor area, which is not addressed in this bill and which this committee must address soon. That will get into the further points of the problem. But, even so, there will be a large dollar figure there.

Senator BAUCUS. I guess I am wondering about the degree to which noncompliance could be reduced if the Tax Code—I know this sounds like pie in the sky—were greatly simplified.

It strikes me that a lot of the provisions in this bill to reduce the compliance gap are additional paperwork. And a lot of people complain about too much paperwork these days. Frankly, the small thrust of this is somewhat counter to the administration's general philosophy in regard to paperwork. And I think that's right; I think there is too much paperwork.

Is there some realistic way to greatly simplify the Tax Code so that people have a better idea as to what the law is—what their requirements really are? Does that make any sense here? Will that make any difference in reducing the compliance gap?

Mr. CHAPOTON. Unquestionably. I think simplifying the Tax Code and making it perceived as more fair would increase compliance. It is a difficult task, with which we deal daily.

Senator BAUCUS. Do you think it's worth our while to try to undertake that effort? In your candid view, is it a waste of time?

Mr. CHAPOTON. No; I think it is always worthwhile to undertake that effort. Unfortunately, there are no short, easy answers. But it is worthwhile in every case when we deal with a legislative change to keep in mind the simplicity of it.

Senator BAUCUS. I appreciate that.

My time is up, but could we get at least $10-$12-$15 billion more here?

Mr. CHAPOTON. Senator Baucus, I simply cannot estimate that off the top of my head.

Senator BAUCUS. Thank you very much.

Senator GRASSLEY. I have some questions, then I will call on Senator Chafee and Senator Symms.

It is going to be argued by some people that the civil fraud penalty is not necessary and will discourage corporations from getting qualified directors and officers. I would like to have you comment on the merits of those arguments, Roscoe.

Commissioner EGGER. Well, I will comment, then Mr. Chapoton may wish to chime in.

Our feeling about it is that, with only a criminal penalty available, many, many times the corporate officers, the individuals who are really responsible for corporate fraud, sort of get by with it because the facts are that we have to prosecute them criminally, if at all. There are no civil sanctions.

The upshot is that we think that from time to time the corporate officers are a little more willing to engage in those activities that may consititute tax fraud because there aren't any personal sanctions that are really likely to be imposed.

So my feeling about it is that I believe it is supportable; I think it's a provision that will go a long way to discourage that kind of activity within corporations.

Mr. CHAPOTON. I would just add to that, Mr. Chairman, that the penalty as proposed in your bill applies only where there is knowing participation in the fraud. And I think, once it's clear that the knowing requirement is clearly in the law, it should not discourage a person from taking directorships and participation in the tax return process of a corporation.

Senator GRASSLEY. Later this morning we are going to hear from James Rowen, one of the most powerful spokesmen for the penalty for substantial understatement, that we call the tax shelter or the audit lottery penalty provision.

Some have expressed concern that this penalty may fall on the small guy, the low-income person or the small business person. I would appreciate your reaction to that accusation.

Commissioner EGGER. I think I mentioned earlier, Mr. Chairman, that we have taken a preliminary look at it. And our preliminary—and I want to emphasize preliminary—survey indicates that something less than 5 percent of the individual returns in the low-income category, or at all, would be affected, and for the most part not in any low-income categories. The same would be true, by and large, of small corporations; a somewhat even lower percent—around 3 percent.

So, we don't feel that there is any risk on that side of it. Our concern, quite frankly, is the imposition of penalties on larger corporations, where the numbers just tend to be big and where the items are perfectly legitimate debates; but, nonetheless, just because of the size of things they tend to be large numbers.

Senator GRASSLEY. We have run into a consistent criticism, on not only our bill but even the administration's withholding proposals, that provisions like our capital gains reporting proposals and our tip reporting proposals make the paperwork burden too great.

Senator Dole and I, like the administration, are concerned with providing a proper balance between the benefits and the burdens of compliance. What guidance can you offer the committee on this recurring issue. Particularly, I would like to have you comment on Secretary Regan's dismissal of the banks' paperwork objections to withholding, and ask you if these are not equally applicable as well to the securities and commodities broker as well.

Mr. CHAPOTON. Mr. Chairman, our initial review indicates, on the withholding requirement, that we have proposed that it would not be unduly burdensome. But we are seeking and obtaining further information on that very point. That is a critical question, and we want to be sure that we are right in our conclusions that the burden would not be too great. We have not had an opportunity to do that same work in the area of capital transactions; though, as has been pointed out, in most of these transactions, the information is already in the broker's hands, and is already reported to the customer. So, indeed, it might be less. But we want a chance to look at that further.

Senator GRASSLEY. Do you have anything to add to that, Commissioner?

Commissioner EGGER. No; I would simply say that most of the provisions with respect to information reporting would fit into the systems that by and large tend to be in place already. So, either from the withholding point of view or from the information point of view, I am not persuaded that there is that significant an additional paperwork burden.

Senator GRASSLEY. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

I would like to ask the Commissioner how he reconciles the need to have greater taxpayer compliance with the facts that the reductions in personnel now means that no longer will taxpayer assistance be provided in many of the regional IRS offices?

Commissioner EGGER. Senator Chafee, the reduction in taxpayer assistance is simply one of budget priorities, among other things. But also, we have shifted the emphasis in the taxpayer service program. We were very, very carefully examining that this year during this filing season to see whether or not the methods that we have used in recent years are really very effective. We are beginning to see that some of them very well may not be.

We have no intention of not supplying taxpayers with the information they need to prepare their tax returns; however, we have gotten out of the business of preparing those returns directly, except for individuals who really need it—in the case of handicapped people, and so on. We have not reduced it otherwise this year, but we do plan to next year to make some fairly significant changes in our taxpayer service program.

Senator DOLE. There have been some stories reported that that was no longer available except for the blind, the lame, and Members of Congress. [Laughter]

Senator CHAFEE. Maybe the first two categories cover the third.

Senator DOLE. Yes; we have three chances there. [Laughter]

But Members of Congress are not provided that service.

Commissioner EGGER. That is correct, Senator Dole.

Senator DOLE. In case the media wanted to correct the misimpression.

Senator CHAFEE. Let me just say this. In my own State the service has been ended. Now, I don't know whether it is available for the blind and so forth, but for the normal taxpayer who once upon a time could come in and get very substantial help, that practice has ended. Is that not correct?

Commissioner EGGER. We have ceased preparing returns on a one-on-one return basis; that's right.

Senator CHAFEE. And you have gone to what? A group preparation?

Commissioner EGGER. Yes, sir.

Senator CHAFEE. Well, that makes some sense. Let me ask you—on page 12 of your testimony, Mr. Egger, you talk about the partnership problem and the fact that when all partners are distributed around each one can battle up through a separate court or a separate administrative procedure. You ask that the partnership have a single judicial proceeding. That makes a lot of sense. Now, what is being done about that?

Commissioner EGGER. We have been working with the Treasury and with outside groups, and so on, to pull together a legislative proposal which we fully expect to see in place as quickly as it can possibly be done.

Our concern is with these large tax-shelter partnerships where there will be as many as 2,000 or 3,000 investors in a single partnership in diverse geographical locations. And the ability to handle those cases——

Senator CHAFEE. Well, I appreciate the problem. But I was wondering if you are not doing something about it, shouldn't we be doing something? Can you do that under your administrative powers?

Commissioner EGGER. No, no; it has to be by legislation.

Senator CHAFEE. But this problem is not addressed in the act which Senator Grassley introduced, I believe.

Commissioner EGGER. That's correct. It was in my testimony that we hoped the committee would consider inserting that.

Senator CHAFEE. Do you have any legislation accomplishing that?

Commissioner EGGER. We have legislation which we have nearly finished drafting, and we hope that the Treasury will present that as a possible——

Senator CHAFEE. Well, I would hope so. It makes a good deal of sense. Although I don't know whether the sponsor of the act agrees.

Mr. CHAPOTON. Senator Chafee, we will be coming forward with a proposal. We work very closely with Mr. Egger and his people and the committee staff.

Senator CHAFEE. Let me just say this, Mr. Chairman. I think every one of us feels that once you start having a breakdown in the compliance with the income tax procedure, this trend accelerates at a tremendous speed. If one person can get away with it, then another figures he should get away with it. And whether it is the audit lottery, or whatever it is, once this system reaches a point where people can beat the game, they will try this. I just wonder whether the reduction in personnel that we have done to the IRS has been correct.

I don't want to pick on dentists—they are a fine group—but there are an awful lot of them at home that get paid by cash. I just wonder how that situation is handled.

Commissioner EGGER. We are very concerned about that, and obviously that is all a part of this effort here, to try to get at some of those things through information reporting without going so far as to place a burden on individuals as such.

Information reporting by individuals on non-business-type or non-deductible-type payments has been tried in the past, I believe, and is simply not successful.

Senator CHAFEE. I must say I'm astonished at the amount of revenue loss which is suggested in this testimony by you, Mr. Egger. Now, I think trying to collect where there isn't the money that we probably can't change that a great deal, but certainly we want to have the compliance to forestall the snowballing of this.

My time is up. Thank you, Mr. Chairman.

Senator GRASSLEY. Thank you, Senator Chafee.

Senator CHAFEE. And I want to say, unequivocally, that I am fond of all dentists in my State. I don't want that to get out of control. [Laughter.]

Senator GRASSLEY. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

I was interested in the question that Senator Baucus asked you, Mr. Chapoton and Mr. Egger, because it appears to me that we spend all of our effort trying to encourage voluntary compliance, but I think we all agree that when the tax rates were at 70 percent it encouraged people not to comply or at least to look for tax shelters outside of normal operations.

Have you had any indications yet, just by the little bit of rate reduction that happened in the tax bill last year, of increased compliance?

Commissioner EGGER. We have obviously not had any returns processed. So we are not in possession of any official information in that respect, because we are just now receiving returns covering the 1981 year. However, in some of my discussions with practitioners and others outside the Government there is every indication that the drop from 70 percent to 50 percent in the top bracket has had some inroads with respect to the tax shelter business.

Senator SYMMS. Well, if that is the case, why don't we direct some of the efforts and the resources of the IRS and the Treasury Department to develop tax legislation that would have a protection for the lower income worker but also, then, would be somewhat of a gross income tax, so everybody would know that everybody is paying their fair share, and simplify the whole thing? I don't think you would have any compliance problems if you had something that appeared to be just.

Mr. CHAPOTON. Senator, a lot of effort has been put into that type of proposal from time to time. So far, no one has come up with a gross income type tax that seems to work well. But a simpler system would certainly be desirable. We simply don't have a proposal to arrive at that yet. But that is no reason for us to stop working.

Senator SYMMS. I really want to encourage you to try to get one; because I think it's fine to try to talk about a voluntary compliance system, but I could give you a good example, Mr. Eggers—the Caldwell Rotary Club, which is a small rotary club in Caldwell, Idaho. Their treasurer of the club moved from Caldwell to Twin Falls, so nobody filed their tax return last year. We talk about needing more IRS agents. But they are a nonprofit club, and they had $300, or something, in the treasury of the club. When they finally got around to getting their tax return filed, because of an oversight, they got a bill for $2,560 from the IRS for being 256 days late in filing. They had no tax liability due, but yet they got this bill for $2,560. It's absolutely outright harassment. That makes everybody in that rotary club hate the IRS.

So it just encourages good honest people to despise the unnecessary harassment they get. And some bureaucrat in the IRS could have easily waived that and said it was a mistake. But no, that doesn't happen. So that puts me in a position, when you come over here and talk about wanting to hire 5,000 revenue agents, I believe that means 5,000 more people to go out and harass innocent taxpayers.

Commissioner EGGER. I don't know anything about the case you are talking about, Senator.

Senator SYMMS. Well, that's the kind of thing that happens every day in this country.

Commissioner EGGER. If there were no tax liability on the return, I would hope that we followed our normal procedure which requires notifying the organization that the penalty could be abated for reasonable cause.

Senator SYMMS. They were fined $10 a day for late filing. But there is no tax liability.

See, that could all be avoided. Senator Baucus talked about a simplified tax return. I can't believe, with all the thousands of people we have working at Treasury and the IRS, that you can't assign a group of 30 or 40 of them and have them write a simplified Tax Code that charges people on a gross income tax rate, and do away with all of this. We could file our taxes on a 3-by-5 card.

Mr. CHAPOTON. Just one thing you get into immediately when that comes forward is, it's always listed as an option, because we want to make sure taxpayers are protected. And, as soon as it's an option, well-informed taxpayers, and indeed most taxpayers, will then compute their returns both ways—the simplified way and the more complicated way.

So, it doesn't really work unless it is the one and only way to do it, and so far, we as a group, we and the Congress, have not been willing to come forward with that.

Senator SYMMS. Mr. Chapoton, I have a civil fraud penalty bill introduced that concentrates the effort on the fraud part of the bill and increases the fraud penalty. Have you had an opportunity since we discussed it last year to come up with a position on it?

Mr. CHAPOTON. No, Senator, we haven't; though we have spent a good deal of time on that bill. As I said last summer, I believe, it goes in the right direction in that it makes the penalty fit the crime. There is some disagreement in the enforcement levels at both Justice and IRS on which way it cuts; that is, some say that it will make it more likely that a penalty will be imposed, because otherwise the penalty is too unreasonable in relation to the amount of tax involved. Others say it would undercut completely the in terrorem effect of the present penalty provisions. We will take a position, but we would like a little more time to consider it.

Senator SYMMS. Mr. Chairman, could I ask one more question?

Senator GRASSLEY. Yes.

Senator SYMMS. Thank you.

Mr. Chapoton, have you had an opportunity to do any analysis of the so-called tax gap, and particularly in the area of savings and capital gains, where I think we do know that most of the money that is paid in dividends and interest, or a great percentage of it, is reinvested? How much worse off would the savings pool be in the United States and how much worse off would the economy be, if we were getting all this collected, than it is today?

Mr. CHAPOTON. No, Senator. We have done analysis on the effect of the proposed withholding at a 5-percent rate, as we put it forward. That does not meet tax liability on those savings in every instance; in most instances it is lower than tax liability. We think that has no adverse effect on savings.

But as far as overall compliance on savings—no, we have not done any such study.

Senator SYMMS. Thank you.

Thank you, Mr. Chairman.

Senator GRASSLEY. Senator Dole.

Senator DOLE. I have no other questions, I know there are a number of outstanding witnesses yet to be heard.

But I am serious. You know, if we started withholding in January of 1983 we would pick up about $10 to $12 billion that year, plus all the other billions you would pick up which might offset the need to even talk about anything with the July 1 individual tax cut. I am not suggesting it will happen that quickly, but I am suggesting that if in fact we adopt the bill now before us, that doesn't mean we are going to back off from what might be a more effective tax collection. I am certain that is the view of both the Treasury and the Commissioner. Is that correct?

Mr. CHAPOTON. That is correct.

Commissioner EGGER. Yes; indeed.

Senator DOLE. I do have some questions that Senator Matsunaga asked me to ask, with reference to restaurant employees and the tip area—which will probably be somewhat controversial because they haven't paid taxes, and they don't know how good it feels. [Laughter]

QUESTIONS FROM SENATOR MATSUNAGA AND COMMISSIONER EGGER'S RESPONSES

1. What would be the cost or difficulty for restaurant employers to comply with the proposed charged tip reporting requirements?

IRS does not have any good way of precisely determining the cost to restaurant employers of complying with the proposed charged tip reporting requirements. We know that the basic document from which charge tips derive, i.e., the paper charge slip, already exists and enters into the employer's system of books and records. Therefore, there is no need to create a new source document. Employers would need to compile these charge tips by employee in order to be able to report the total annual amount on the Form W-2. Furthermore, the proposal would not require the filing of new or additional documents with the Federal Government, since the amount of charged tips would be shown on the Form W-2 which is already filed by the employer for each employee. It is reasonable to assume in light of the above, that the additional burden on employers, while real, will probably not be too substantial.

2. What is the estimated revenue gain from the proposed charged tip reporting requirement?

IRS estimates additional revenue of $200 million per annum from the additional charged tip reporting requirement.

3. How would tip sharing arrangements be handled for reporting?

The information available to IRS indicates that charge tips are about 12½ percent of all tips. Thus, the reporting of all charged tips directly attributable to an employee should allow the employee ample flexibility to accommodate any shared charged tips by adjusting the total amount of tips which must now be reported to employers by employees under existing law. The IRS does not plan to dictate to employees or employers the precise rules for handling tip sharing arrangements.

Senator GRASSLEY. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Gentlemen, I would like to make one more attempt to try to elicit from you your private, and hopefully now public, thoughts on how we can reduce that noncompliance gap a little bit more.

Like Senator Chafee, I think the American public knows about this and is outraged at the size of this noncompliance gap. Certainly this committee is, and I'm sure most of the complying taxpayers are, too. I am a little surprised that I don't hear more outrage in the tone of voice from all of you over all of this. I am just curious. What do you suggest? What do we do to get that down even further?

Mr. CHAPOTON. I'll take it first, Senator Baucus.

I think your point is well taken. Maybe we have become a little more hardened to it; but one should react with outrage when one sees those figures, and indeed, it is a very big concern to us.

We also feel a great sense of frustration because, often when we come forward with proposals such as dealing with the independent contractors, Congress puts a moratorium on our ability to move in that area for a year or two. So, while we see some figure, I believe $26 billion, involved in the nonfarm business sector, a lot of that dealing with the cash payments, with the independent contractor problem, then we feel a great sense of frustration. But I guess we become somewhat hardened to it.

I would just say that one should be outraged by it, and one should keep looking for ways to close it. We have not found any. This is a step in the right direction. It's a small step, as you point out, but we need to keep working.

Senator BAUCUS. Well, I just encourage you to keep coming back with those proposals. You are the experts. You are closer to the problem, theoretically, and I think probably you have a better idea of how to solve this than do we.

Commissioner EGGER. Senator Baucus, let me comment in this respect, that it is moves such as this that I believe will give the public a great deal more confidence in the system than they apparently have today.

If you couple two things—one, confidence in the system, which in my opinion will raise the level of compliance all by itself, with the demonstration and the clear belief on the part of the taxpaying public that sizable errors in tax reporting will be detected and corrected, then I think that we will go a long way to coming a lot closer to that solution.

Senator BAUCUS. Do you think the increased penalty provisions of this bill are sufficient?

Commissioner EGGER. At the moment I believe they certainly are. We have to live with them a bit before we can see what the real impact is going to be just as the ones that came into the 1981 act we think are extremely helpful, but we have only begun to live with them. We are just getting to the point where we can begin to apply those rules.

Senator BAUCUS. Thank you.

Senator GRASSLEY. Senator Danforth has a question in regard to the exemption in section 202 from the Paperwork Reduction Act.

He is interested in the purpose of the exemption and whether or not OMB to date has had any adverse effect on the issuance of regulations and forms, and has it cost the Treasury any revenue.

Mr. CHAPOTON. Senator, there has been an ongoing discussion between Treasury and IRS and OMB on the application of the Paperwork Reduction Act, and also other both regulatory and statutory provisions relating to review at the Office of Management and Budget of both forms and tax regulations.

The Treasury Department has supported Vice President Bush's task force on reducing regulation. And the Office of Management and Budget has agreed that there are special circumstances dealing with tax regulations, because indeed they are for the most part helpful to taxpayers in knowing what the requirements of the law are. And the OMB has taken that into account.

It is still an ongoing process, though. I think there have not been any substantial delays to date in the regulation area. The Commissioner might have a different view in the form area; but, in regulations, I believe there have been no substantial delays as the result of that review.

Commissioner EGGER. We have had none in the regulation area. There are ongoing discussions as to the scope of the review by OMB in regard to the Paperwork Reduction Act. They are concerned, quite properly, with being able to see how close we can come to the targets that the Congress has enacted—25 percent reduction. And when you recognize that the IRS produces about 60 percent of the paperwork burden in the United States, obviously a great deal of the question of whether or not we meet that 25 percent reduction target is going to fall with us.

So, we are working very closely with OMB on it, and hopefully we will arrive at a meeting ground where both the interests of tax administration and the interests of keeping the paperwork burden to a bare minimum on the public can be met.

Senator GRASSLEY. That's all the questioning. Senator Chafee and Senator Symms have no more questions.

Thank you very much for your testimony, and we look forward to working with you as this bill evolves through the process.

Commissioner EGGER. Thank you, Mr. Chairman.

Mr. CHAPOTON. Thank you.

Senator GRASSLEY. Our next witness is Mr. William J. Anderson, Director of the General Government Division, General Accounting Office.

Mr. Anderson, could I ask you to summarize your testimony to the greatest extent possible?

Mr. ANDERSON. Yes, sir. I came prepared to do so.

Senator GRASSLEY. Your whole statement will be put in the record.

## STATEMENT OF WILLIAM J. ANDERSON, DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.

Mr. ANDERSON. Good morning, Mr. Chairman and gentlemen.

I would like to begin by introducing the gentlemen at the table with me. To my right is Carl Trisler, an audit manager in my division's tax area; and to my left is Dan Harris, a group director in charge of a broad range of our work at IRS.

I would like to start off by saying that we strongly support the objectives of S. 2198, the proposed Taxpayer Compliance Improvement Act of 1982.

Our position is based on the urgent need for IRS to cope more effectively with the problem of decreasing compliance by the American public. We spoke to this same issue last week before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Government Operations Committee during hearings involving the adequacy of IRS's resources.

We pointed out in our testimony there that the most disturbing trend in tax administration today is the increasing unwillingness of taxpayers to be honest in their self-assessments of amounts due the Government.

IRS's taxpayer compliance measurement program provides insights into the situation. I won't bother reciting all the statistics; our full statement contains many of them. But it is a fact that if you track back over time there has been a downward trend in compliance by the American taxpayer.

There are just a few figures that I will cite: In 1965 overall compliance for individuals as measured by IRS's taxpayer compliance measurement program, was about 94.3 percent. By 1976 it had gone down to 92.3 percent. If compliance continued at 92.3 percent, in 1981 it would have indicated unpaid taxes of about $28 billion.

In addition, IRS's recent update of a 1979 study it did shows a great increase in the size of the tax revenue loss in recent years, a surprising increase, to an amount much larger than that indicated by the original 1979 study which showed that for tax year 1976 individuals failed to pay about $28 billion in taxes.

But I will say that even the 1979 study was significant, because it indicated that underreported income was IRS's major problem, accounting for 72 percent of the tax gap. To that time IRS had based its estimates of the problem on the taxpayer compliance measurement program, and really hadn't understood how that program was understating the amount of underreported income.

I noticed in describing their latest study they indicate that TCMP understates underreported income by a factor of about 4 or 5 to 1. So they had a completely misleading picture regarding where the problems were.

That leads me to the reasons that we are so supportive of S. 2198. Its primary thrust is aimed at improving IRS's ability to detect underreporting. It does this in several ways.

First, it would expand the scope of information reporting by covering certain gaps in existing coverage: Interest on bearer instruments, broker transactions, tax refunds, charge tips.

Second, it would improve the quality of that reporting already required by strengthening the penalty provisions for unsatisfactory compliance.

And, third, it would authorize the Secretary to compel reporting on magnetic media, where this is possible and feasible.

I will briefly speak to the other provisions and then close.

First, interest payment computations. Our earlier report on nonfilers was critical of the practice of paying interest on refunds to nonfilers who filed returns after being caught. S. 2198 would eliminate the payment of any such interest for any day before the date on which the tax return was filed.

Two, the bill provides for semiannual determination of the interest rate used for tax administration purposes. We recommended this in a 1980 report. There is no reason to believe that the volatile movement of interest rates experienced in the recent past will not recur. Therefore, semiannual adjustment would seem to be fair and equitable to all concerned. We also agree with the provision for semiannual compounding of interest, as a matter of policy and good business.

We also agree with the bill's sponsors' comments at the time of introduction regarding the need for additional IRS resources.

Indeed, that was the theme of our testimony last week on the House side.

In conclusion, Mr. Chairman and gentlemen, our work over the past several years indicates that declining voluntary compliance with the tax laws is a serious problem. In view of the substantial loss in Federal revenue that is resulting, the Government needs to make a concerted and balanced effort to recover unpaid taxes, particularly those due on unreported income.

Though we have not analyzed the bill in depth, it addresses many issues and concerns we have raised in the past. Overall it is a step in the right direction, and together with additional resources should facilitate IRS's enforcement of the tax laws.

If you have no objections, Mr. Chairman, we would like to provide the subcommittee with more specific comments on the bill at a later date.

That concludes my summary comments, sir.

Senator GRASSLEY. Thank you.

[The prepared statement follows:]

STATEMENT OF

WILLIAM J. ANDERSON, DIRECTOR,

GENERAL GOVERNMENT DIVISION

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist your Subcommittee in considering the problem of the income tax compliance gap and the need for S.2198, the Taxpayer Compliance Improvement Act of 1982, to help address this problem. Our testimony is based primarily on our overall experience gained from conducting audits of tax administration operations and activities over the past several years.

We first addressed the issue of unreported income in July 1979. At that time, we issued a comprehensive report in which we estimated that about 5 million individuals and couples owing about $2 billion in taxes did not file tax returns for tax year 1972, the year for which the most current data was available for analysis. We also estimated that IRS had only been able to secure delinquent returns from about 12 percent of the estimated 5 million nonfilers. Since July 1979, we have issued numerous reports and provided extensive testimony addressing IRS' tax administration activities and the actions needed to improve IRS' compliance enforcement efforts, particularly against the unreported income problem. We are also presently conducting several reviews of various IRS programs which are directed wholly or partially at addressing the unreported income problem. Appendix I to my statement lists the reports issued and testimonies delivered since July 1979, as well as reviews currently in progress, which relate to the income tax compliance problem.

Mr. Chairman, S.2198 addresses several issues and concerns we have surfaced in our reviews. It also contains some solutions we too have proposed in the past. Thus, while we have not had sufficient time to do an in-depth analysis of the bill's individual provisions, we endorse its overall objectives. It seeks to reduce the shortfall in Federal tax revenues by focusing on noncompliance attributable to some types of unreported income. As you know, unreported income is IRS' most serious compliance problem.

## TAXPAYER NONCOMPLIANCE DIRECTLY AFFECTS AVAILABLE FEDERAL REVENUES

The Federal Government's financial well-being depends, in large measure, on whether people are willing and able to support our Nation's tax system. The system, which is based on voluntary compliance, is generally regarded as the most efficient, effective, and fair approach for carrying out the unpopular function of collecting the revenue necessary for national defense and other essential Government activities. The tax system provides over 90 percent of the revenues for financing the Government's programs and activities. In 1981, this amounted to about $600 billion.

To assure that the tax system provides maximum revenue at least cost, IRS must strive to achieve the highest possible degree of voluntary compliance with the tax laws. This is very important because even a slight decrease in compliance levels translates into billions of dollars of foregone tax revenue annually.

Despite the importance of our Nation's tax system, however, it is not in as good health as it should be. There is a trend toward contempt and abuse of the system which seriously undermines the basic concept of voluntary compliance on which the system depends. Extensive evidence is available to show that noncompliance among both corporate and individual taxpayers is a serious problem and is getting worse.

The Subcommittee has already well documented the extent of the voluntary compliance problem. Therefore, we will not belabor the point. The problem is well-recognized and it is now more important to focus attention on what can be done to close the income tax compliance gap and reduce the shortfall in Federal revenues. In this regard, we believe that consideration of S. 2198 is a step in the right direction.

S.2198 SHOULD HELP IRS
REDUCE THE COMPLIANCE GAP

S. 2198 seeks, among other things, to limit or reverse the growth of the income tax compliance gap by (1) improving information reporting, and (2) providing for comprehensive revision of the penalty and interest requirements. The sponsors of the bill also recognize the need for increasing the level of IRS' resources. We generally agree that improvements in these broad areas are vital for IRS to effectively deal with the decline in voluntary compliance, especially that aspect involving unreported income.

We previously testified that improvements--similar to those included in the proposed legislation--were needed in information reporting. Such reporting and the follow-on matching program represent a powerful tool for promoting taxpayer reporting of income. IRS has developed data showing that there is a direct correlation between the presence of an information document and the level of compliance. And there is, indeed, potential for (1) expanding the income subject to information reporting and matching, and (2) improving the quality of that reporting already required--principal objectives of the proposed legislation.

The proposed legislation calls for information reporting on (1) interest payments on Federal debt and bearer obligations, (2) charged tips, (3) transactions involving capital gains on securities and commodities, and (4) State tax refunds. In earlier testimonies, we identified interest on the U.S. public debt and State tax refunds as potential candidates for information reporting and the document matching program. We also suggested that for other types of income, such as alimony, surrogate information documents like the 1040 return may already exist. We have not specifically considered tips or capital gains on securities and commodities in our previous work.

The proposed legislation also seeks to improve information reporting through specific measures designed to better insure that IRS can use all of the information documents it gets. Specifically, the bill, among other changes, gives IRS authority to require payers filing large numbers of information documents to file on computer tapes instead of paper and increases the penalty which IRS can assess if documents are submitted without a taxpayer identification number.

We agree with the importance of payers submitting information documents on magnetic media. Such documents are much more likely to be used since it is considerably less costly for IRS to process magnetic media than documents submitted on paper. We testified in 1979 that, at that time, it cost IRS $400 to process 100,000 documents submitted on magnetic tapes as opposed to over $20,000 to process the same number received in paper form. Over the years, IRS has successfully promoted more computer media reporting. Notwithstanding, of 645 million information returns received by IRS in 1980, more than 300 million were submitted on paper. In an October 1980 report (FGMSD-81-4), we recommended that IRS seek ways to further increase the filing of information documents on computer readable media. We also suggested that IRS investigate the use of optical character recognition (OCR) equipment to transcribe nonwage paper information documents and consider sharing equipment with the Social Security Administration. The Social Security Administration uses OCR equipment to process millions of withholding statements (W-2s) submitted by employers.

The penalty provision is also important. IRS cannot compare or match information documents to tax returns without the identification number, and it is costly for IRS to research its own records or to contact payers to get missing numbers. That problem causes millions of documents to now go unused. Increasing the penalty should help, if IRS enforces it. We previously found, however, that IRS generally does not assess penalties on payers who submit documents lacking taxpayer identification numbers. The penalty was seldom assessed because, according to IRS officials, the process was not cost beneficial. Raising the penalty amount should take care of that problem and serve as a greater deterrent.

A second problem we noted during our earlier review, was the lack of any definition or guidance on what constitutes reasonable cause for submitting an information document without an identification number and what evidence payers should provide IRS to show that sufficient effort was made to obtain an identification number. If these questions have not been answered, IRS may continue to make little use of the penalty provision. However, the withholding provisions included in the proposed legislation should help. This is not to say, however, that IRS should stop using other approaches to improve the completeness of the documents it receives. For example, when IRS does find an identification number for an incomplete document, it notifies the payer. It also asks the payer to correct appropriate records and include the identification number on future submissions.

In addition to the need for measures to improve the completeness of information reported, we agree measures are also needed to protect against nonreporters. In this regard, penalties and interest--the second principal component of the proposed legislation--are important tools to promote better information reporting and taxpayer compliance. We previously testified about problems in assuring that payers--including Federal agencies--submit all required information documents. Tough penalties are a necessary part of the effort to promote or enforce such reporting. Higher penalties will no doubt help. Our prior work, however, indicates a more fundamental problem that must also be addressed--IRS needs to do more to identify and pursue noncompliers.

In addition to the penalties associated with information reporting, the bill also proposes other penalties and interest requirements. Section 113 of S. 2198, for example, makes some changes in interest payment computation which we have previously identified as needed and which we support. In our report on tax return nonfilers (GGD-79-69, July 11, 1979), we noted that interest was paid on refunds to nonfilers who filed their return after being caught. IRS had to pay out such interest because it did not process these returns within 45 days after they were filed, as required by law. To avoid having to pay such interest, we recommended that IRS establish a priority system to make sure that delinquent tax returns involving refund claims are processed within 45 days of being filed. It appears that S. 2198 would eliminate this problem by prohibiting the payment of interest on overpayments associated with tax returns filed late. Thus, we support this provision of the bill. Also, in our report on nonfilers we recommended that the Congress consider the matter of imposing a penalty on nonfilers due refunds, and we proposed various alternatives for imposing such a penalty. Thus, we support the proposed legislation's requirement for a new minimum penalty for the extended failure to file any income tax returns.

Section 112 of S. 2198 provides for a semiannual determination of the rate of interest. In a previous report (GGD-81-20, October 16, 1980), we recommended such a semiannual adjustment and reported that in fiscal year 1979 an additional $119 million could have been assessed in interest charges on delinquent taxes if such a provision were enacted. There is no reason to believe that the volatile movement of interest rates experienced in the recent past will not recur; therefore, semiannual adjustment of IRS' interest rate would seem both fair and equitable. We also note that section 111 provides for semiannual compounding of interest. We agree with this provision as a matter of policy and good business.

In announcing S. 2198, the bill's sponsor and co-sponsors indicated that increased IRS resources will also be needed to stem the growth of the noncompliance problem. Specifically, they support the need for increased resources for collection activities as requested in the fiscal year 1983 budget and urge the Administration to increase funding in the budgets for fiscal years 1984 and 1985.

We agree that additional resources are needed to reduce noncompliance with the tax laws. Just 5 days ago before the House Government Operations Subcommittee on Commerce, Consumer and Monetary Affairs, we stated that various factors, including declining voluntary compliance, have contributed to growth of IRS' workload but that IRS' resources have not kept pace. We also pointed out that administrative and legislative actions can be taken which would allow IRS to make more efficient and effective use of its existing resources. In our view, however, such actions alone will not be sufficient. We believe an increase in IRS' resources is needed to maintain the integrity of our tax system and collect the revenues necessary for financing essential

Government activities. Such an increase, within reason, would not increase the Federal budget deficit. This is because IRS' compliance programs, on the average, generate tax revenue in amounts that far exceed the programs' cost. The full text of my statement before the House Subcommittee is attached as appendix II.

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In conclusion, Mr. Chairman, our work over the past several years supports the fact that declining voluntary compliance with the tax laws is a serious problem. In view of the substantial loss in Federal revenue that is resulting, the Government needs to make a concerted and balanced effort to recover unpaid taxes, particularly those due on unreported income. While we have not yet analyzed the bill in depth, it addresses many issues and concerns we have raised in the past. Overall, it is a step in the right direction, and together with additional resources, should facilitate IRS' enforcement of the tax laws. If you have no objections, Mr. Chairman, we would like to provide the Subcommittee with more specific comments on the bill at a later date.

This concludes my prepared statement. I would be pleased to answer any questions.

## GAO Reports and Testimonies Issued Since July 1979 And Ongoing Jobs Related To The Income Tax Compliance Problem

### Reports

| | |
|---|---|
| 7/11/79 | GGD-79-69: Who's Not Filing Income Tax Returns? IRS Needs Better Ways To Find Them And Collect Their Taxes |
| 8/3/79 | GGD-79-43: IRS Can Improve Its Process For Deciding Which Corporate Returns To Audit |
| 8/15/79 | GGD-79-59: IRS' Audits Of Individual Taxpayers And Its Audit Quality Control System Need To Be Better |
| 11/6/79 | GGD-80-9: Improved Planning For Developing And Selecting IRS Criminal Tax Cases Can Strengthen Enforcement of Federal Tax Laws |
| 1/24/80 | GGD-80-33: IRS Computer Assisted Audit Program |
| 2/11/80 | GGD-80-34: IRS Efforts To Detect And Pursue Corporate Nonfilers |
| 9/5/80 | GGD-80-98: IRS Needs To Reconsider Its Examination Strategy For Certain Partners |
| 10/16/80 | GGD-81-20: New Formula Needed To Calculate Interest Rate On Unpaid Taxes |
| 10/20/80 | FGMSD-84-4: IRS Can Expand And Improve Computer Processing Of Information Returns |
| 4/29/81 | GGD-81-25: Streamlining Legal Review Of Criminal Tax Cases Would Strengthen Enforcement Of Federal Tax Laws |
| 5/12/81 | GGD-81-66: Observations Concerning the Internal Revenue Service's Management of Criminal Tax Cases |
| 7/8/81 | GGD-81-83: Illegal Tax Protesters Threaten Tax System |
| 7/23/81 | GGD-81-80: Bank Secrecy Act Reporting Requirements Have Not Yet Met Expectations, Suggesting Need for Amendment |
| 11/5/81 | GGD-82-4: What IRS Can Do To Collect More Delinquent Taxes |

## Congressional Testimonies

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|---|---|
| 7/16/79 | Before the House Ways and Means Subcommittee on Oversight on IRS' efforts to identify and pursue income tax nonfilers and underreporters |
| 7/17/79 | Before the House Ways and Means Subcommittee on Select Revenue Measures on compliance problems of independent contractors |
| 9/6/79 | Before the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs on the subterranean economy |
| 10/11/79 | Before the House Ways and Means Subcommittee on Oversight on the efforts of IRS' Criminal Division to detect and deter underreporters |
| 11/15/79 | Before the Joint Economic Committee on the underground economy |
| 11/29/79 | Before the House Banking, Finance, and Urban Affairs Subcommittee on General Oversight and Renegotiation on the use of currency and foreign account reports to detect narcotics traffickers |
| 12/13/79 | Before the Senate Governmental Affairs Permanent Subcommittee on Investigations on IRS' Efforts to Combat Narcotic Traffickers |
| 9/18/80 | Before the House Ways and Means Subcommittee on Oversight on the subject of compliance by Federal Agencies with the requirements to file 1099 information returns |
| 10/1/80 | Before the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs on IRS' document matching program |
| 10/1/80 | Before the House Banking Finance, and Urban Affairs Subcommittee on General Oversight and Renegotiation on Implementation of the Bank Secrecy Act's Reporting Requirements |
| 5/11/81 | Before the House Ways and Means Subcommittee on Oversight on the adequacy of IRS compliance resources for fiscal year 1982 |
| 6/10/81 | Before the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs on IRS' efforts against illegal tax protesters |

7/23/81 Before the House Banking Finance, and Urban Affairs Subcommittee on General Oversight and Renegotiation on the Bank Secrecy Act

3/17/82 Before the House Government Operations Subcommittee on Commerce, Consumer and Monetary Affairs on the adequacy of IRS' resources

Current Reviews

(1) Review of problems IRS encounters in auditing tax shelter schemes

(2) Review of the quality of IRS' corporate tax return audits

(3) Review of IRS' resource management activities

(4) Review of IRS' use of publicity to promote voluntary compliance with the tax laws

(5) Survey of IRS' rewards for information program

(6) Survey of IRS' unreported income program

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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STATEMENT OF

WILLIAM J. ANDERSON, DIRECTOR

GENERAL GOVERNMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON COMMERCE, CONSUMER

AND MONETARY AFFAIRS OF THE

HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

ON THE ADEQUACY OF IRS' RESOURCES

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist your Subcommittee in considering the adequacy of IRS' resources, particularly its resources for fiscal year 1983. Our testimony is based primarily on our overall experience gained from conducting audits of tax administration operations and activities. Over the past several years, we have reviewed and reported on most of IRS' major programs and activities. We will soon issue a comprehensive report on how IRS allocates resources among its various compliance programs.

The thrust of our testimony today, Mr. Chairman, is that IRS needs additional resources to effectively administer our Nation's tax system and collect the revenues required to defend and operate our country. Of course, we continue to believe that administrative and legislative actions can be taken which would allow IRS to make more efficient and effective use of its existing resources. However, these actions alone will not be sufficient. IRS' workload continues to grow because of (1) the decline of voluntary compliance with the tax laws, (2) the increase in the scope and complexity of the laws IRS is charged with enforcing, and (3) the increase in the number of returns filed. IRS' resources have not kept pace with these trends. It is imperative that IRS have sufficient resources to maintain the integrity of our tax system and collect the revenues necessary for financing essential Government activities.

## IMPORTANCE OF TAX COLLECTION ACTIVITIES

The Federal Government's financial well-being depends, in large measure, on whether people are willing and able to support our Nation's tax system. The system, which is based on voluntary compliance, is generally regarded as the most efficient, effective, and fair approach for carrying out the unpopular function of collecting the revenue necessary for national defense and other essential Government activities. As shown in attachment I to my statement, our tax system provides over 90 percent of the revenues for financing the Government's programs and activities. In 1981, the system provided about $600 billion in revenue from all sources, and IRS' budget was $2.5 billion. Thus, the average cost to collect $100 was just 41 cents.

To assure that the tax system provides maximum revenue at least cost, IRS must strive to achieve the highest possible degree of voluntary compliance with the tax laws. But, growing numbers of people in this country are unwilling to comply voluntarily, and even a slight decrease in compliance levels translates into billions of dollars of foregone tax revenue annually. This is very significant in view of the huge deficits the Federal Government incurs to meet its obligations.

## TAXPAYER COMPLIANCE HAS DECLINED

Despite the importance of our Nation's tax system, it is not in as good health as it should be. There is a trend toward contempt and abuse of the system which seriously undermines the basic concept of voluntary compliance on which the system depends. Extensive evidence is available to show that noncompliance among both corporate and individual taxpayers is a serious problem and is getting worse.

One source of evidence is IRS' September 1979 report on income not reported by individuals for tax purposes. This study, coupled with other IRS data, shows that for tax year 1976 individual taxpayers failed to pay taxes totaling up to $27.6 billion. This shortfall resulted from four types of noncompliance:

--Failing to report all income on which tax is due ($20.0 billion).

--Nonfiling of returns by persons with tax liability ($2.5 billion).

--Failing to pay tax reported on returns filed ($1.5 billion).

--Overclaiming of deductions, exemptions, and credits ($3.6 billion).

Had individual taxpayers alone fully complied with the tax laws in 1976, the additional taxes generated would have reduced the fiscal year 1977 Federal budget deficit by 58 percent.

IRS is updating and expanding its 1976 figures and will release new estimates soon. However, some preliminary estimates, not yet finalized and publicized by IRS, indicate that the total tax revenue losses may have tripled since 1976.

Another source of evidence is IRS' Taxpayer Compliance Measurement Program (TCMP), which periodically estimates voluntary compliance levels among individual taxpayers and some corporations who file returns. These studies provide the best available measure of noncompliance involving the overstating of offsets to income (exemptions, deductions, and credits). However, IRS has made other studies which indicate that TCMP detects less than one-half of the estimated unreported income. As shown in attachment II to my statement, unreported income, which is commonly associated with the subterranean or underground economy, is the largest form of noncompliance--accounting for almost three-fourths of the estimated foregone tax revenue in 1976.

Even though TCMP surveys do not measure total taxpayer noncompliance, the results of those surveys can provide some insight into voluntary compliance trends since 1965. These studies show that in the 11 years from 1965 to 1976, compliance rates, in terms of dollars of tax liabilities accurately reported, dropped by 2 percent, from 94.3 percent to 92.3 percent. Had the compliance rate remained at the 1965 level of 94.3 percent, tax assessments in 1976 would have been $9 billion higher.

Compliance among certain taxpayer classes has seriously deteriorated since 1965. Compliance among four of the seven classes IRS measures was below 90 percent in 1976; whereas just one class was below 90 percent in 1965. For example, compliance among individual taxpayers who own small businesses with under $10,000 income dropped from 79.2 percent in 1965 to 43.2 percent in 1976. That means that these taxpayers as a class paid only 43 percent of the taxes they owed in 1976.

The noncompliance problem is not restricted to individual taxpayers. For example, according to TCMP results, compliance among small corporations, those with assets of up to $1 million, dropped about 10 percentage points, from 83.1 to 73.3, between 1969 and 1978. Tax revenue losses for the three corporate classes IRS measured through TCMP in both 1969 and 1978 more than doubled, from $600 million to $1.3 billion between those years. Compliance among those three classes of corporate taxpayers was 88.0, 90.7, and 63.0 percent in 1978. For all the corporate taxpayers measured through TCMP in 1978, including some not measured in 1969, the estimated tax loss was $2.3 billion for 1978. As with individual taxpayers, the major form of the corporate noncompliance was unreported income, comprising about two-thirds of the noncompliance among corporate taxpayers.

Along with the general decline in voluntary compliance among both individual and corporate taxpayers, several special compliance problems and issues have emerged in recent years which further jeopardize the tax system. These include: (1) abusive tax shelters; (2) tax protesters; and (3) use of overseas tax havens. While each of these problems is complex enough to merit its own testimony, I will just highlight them.

--IRS considers the proliferation of abusive tax shelters to be a major tax compliance problem. IRS reports that some 248,000 tax returns involving abusive tax shelters were under examination at the end of fiscal year 1981, at least 50,000 more than 1 year earlier. IRS estimates that abusive tax shelters cost the Government approximately $3.6 billion annually in lost revenue.

--Illegal tax protesters are those who advocate and/or participate in certain schemes that result in tax evasion. IRS estimates that the number of protester returns filed in 1981 totaled about 27,300--a 283 percent increase from 7,100 in 1978.

--Use of overseas tax havens has grown rapidly in the past several years. Because of inherent limitations on U.S. information gathering and enforcement activities in foreign countries, tax havens are an exceedingly difficult compliance problem.

## INCREASING SCOPE AND COMPLEXITY OF TAX LAWS

Interrelated with the noncompliance problem is the scope and complexity of the tax laws which has added to IRS' administrative burden. The tax laws often complicate IRS' audits of tax returns and produce numerous controversies between IRS and taxpayers. Resolving these controversies has become a troublesome and expensive matter for both the Government and the taxpayer.

Recently enacted legislation has created even greater difficulties in interpreting and enforcing the tax laws. For example, while the Economic Recovery Tax Act of 1981 may have simplified tax administration in some areas, it complicated the tax system in others. Those areas, to mention a few, relate to indexing tax rates for inflation, various savings incentives such as IRAs, and the marriage tax penalty. The Economic Recovery Tax Act alone amended, added, or repealed over 200 sections of the Internal Revenue Code.

Changes due to the Economic Recovery Tax Act and other legislation in recent years created the need for new regulations. Available figures show regulations awaiting promulgation increased from 140 in January 1967 to 378 in January 1982, a 170 percent increase. Major tax legislation has caused sizable increases in the backlog; for example, the Economic Recovery Tax Act alone is responsible for 90 new regulations which are scheduled for completion by 1984. The priority assigned to these new projects impacts on the existing backlog by causing further delays in already pending projects.

Legislative changes have also created the need for new and revised tax forms, schedules and instructions. Between 1977 and 1981 such changes resulted in 46 new tax forms and 1,093 revisions to existing forms, 429 of which related to the Economic Recovery Tax Act.

In addition, because of the increasing complexity of the laws, taxpayers are more frequently objecting to IRS' audit determinations and taking advantage of their rights to appeal faster than IRS and the courts can hear the cases. As a result, the IRS Appeals Division backlog increased 2 percent from September 30, 1980, to September 30, 1981, when more than 27,000 cases were awaiting appeals actions. The rate of backlog growth in the courts is much greater, especially in the U.S. Tax Court where the number of cases pending trial increased from 34,000 to 45,400, or 33 percent, between September 1980 and September 1981.

Furthermore, Mr. Chairman, we note as perhaps another indicator of the increasing scope and complexity of the tax laws that, for the first time ever, the Commerce Clearing House published the tax code in two volumes this year rather than one.

## IRS' COMPLIANCE RESOURCES HAVE NOT KEPT PACE WITH GROWING WORKLOAD DEMANDS

As the Federal agency responsible for administering the Nation's tax system, IRS must cope with an increasing workload created by the year-to-year growth in the taxpaying population as evidenced by the increasing number of tax returns filed.

Of course, IRS must also respond to additional workload created by deteriorating compliance and by new tax legislation. IRS has one of the largest workforces of all Federal nondefense agencies and is requesting $2.9 billion to support 88,700 staff years for fiscal year 1983. In the past several years, however, its resources have not kept pace with the growth in its workload.

IRS expects 144 million tax returns to be filed in 1983, including 98 million Form 1040s and Form 1040As. In contrast, only 123 million were filed in 1976, including 83 million Form 1040s and Form 1040As. This is an overall growth of 17 percent. While increases in return filings do not necessarily require proportionate increases in IRS resources, it is still noteworthy that, between 1976 and 1983, the number of returns filed will increase by 17 percent. IRS' resources, however, will increase by only 5 percent, from 84,300 to 88,700 staff years--about a third the rate of the workload increase.

Attachment III to my statement shows the resources and workload trends for major IRS components for fiscal years 1976 through 1983. To illustrate the increasing demands being placed on IRS resources, I would now like to discuss several specific IRS programs and activities.

IRS' examination resources have failed to keep pace with the increase in tax return filings, and the tax revenue shortfall is increasing. As mentioned earlier, filings will increase 17 percent from 1976 to 1983. However, examination resources received from 1976 to date and requested for 1983 will have increased by only 2 percent. This 17 percent increase in filings, combined with the increasing complexity of the returns filed, will reduce coverage from 2.6 percent in 1976 to an expected 1.67 percent in 1983.

Based on TCMP data, IRS projected that a total of $19.8 billion in additional taxes were not assessed in 1980. However, at the 1980 coverage level of 2.12 percent of 1979 filings, IRS' examinations resulted in a recommended $2.8 billion in additional taxes for individual tax returns--a shortfall of $17 billion. IRS recently made preliminary estimates that this tax shortfall is growing at an annual compound rate of 13.5 percent. At this rate, the cumulative shortfall could be as much as $135 billion for the 5 years 1981-85.

IRS' collections resources have also failed to keep pace with growing delinquent account inventories. According to IRS, tax revenue tied up in delinquent accounts will almost triple between 1976 and 1982--increasing from $1.7 billion involving 614,000 accounts in 1976 to an estimated $4.8 billion involving 1.5 million accounts. However, these figures understate the total collection problem because they refer only to the year-end inventories of active accounts receivable. On this basis, IRS would have reported $4.7 billion not collected at the end of fiscal year 1981--but the actual amount outstanding was $20.5 billion. In addition to the $4.7 billion, the $20.5 billion included:

--Accounts which were in notice process ($8.8 billion).

--Accounts classified as currently not collectible ($3.9 billion).

--Installment and deferred accounts ($.8 billion).

--Accounts set aside for further investigation or adjustment ($2.3 billion).

Despite large increases in delinquent accounts, IRS resources devoted to the collection of such accounts was about the same in 1980--about 9,400 staff years--as it was in 1976. However, IRS is requesting an increase to about 10,800 staff years for 1982 and to about 13,700 staff years for 1983. With those higher staffing levels, IRS expects the ratio of active accounts to staff years to be improved.

The fact that IRS is required to administer new and often extremely complex tax laws has also impacted on its resources. The Crude Oil Windfall Profit Tax Act of 1980 is one example. This act is expected to raise more than $227 billion in net additional revenue by 1990. As I stated before this Subcommittee on April 13, 1981, the act is very complex and present compliance levels are unknown. IRS had to undertake this major new responsibility with no increase in resources to date. One result will be an estimated $150 million in foregone revenue that would have been generated annually by the examiners who were diverted from regular examinations to Windfall Profit Tax examinations.

## ADMINISTRATIVE AND LEGISLATIVE IMPROVEMENTS COULD HELP CLOSE THE GAP BUT ADDITIONAL RESOURCES ARE ALSO NEEDED

Various administrative and legislative actions would permit IRS to make more efficient and effective use of its existing resources. However, such actions alone would not be sufficient to counter the growth in workload brought on by decreasing compliance, the increasing scope and complexity of the tax laws, and the increasing number of returns filed. Therefore, additional resources are needed if IRS is to maintain the integrity of the tax system and achieve maximum collection of Federal revenues.

Available Resources Can Be Used More Efficiently

Our work has shown that IRS can improve the management of its compliance programs and other activities to permit more efficient use of existing resources. We have noted, for example, that IRS is at a serious disadvantage in deciding how to best structure its compliance activities to better cause people to comply with the tax laws. IRS lacks sufficient data to understand how its compliance programs, individually and collectively, affect compliance. Even so, IRS has allocated more than half (about 54 percent in 1980) of its compliance-related resources to the examination program on the assumption that this program can achieve a 90-percent compliance level for all taxpayer groups.

Our work has shown that the examination coverage IRS has been able to provide has been inadequate to establish and maintain compliance levels at 90 percent or higher for some taxpayer groups. In fact, the compliance levels for all taxpayer groups that IRS measures have steadily declined since 1965. Furthermore, in allocating compliance resources to and within the examination program, IRS has purposefully foregone optimizing tax revenue. IRS has also favored the examination program over some other programs that are designed specifically to detect unreported income--the major compliance problem.

In a report soon to be released to the Congress, we are recommending several steps that IRS should take to better understand the compliance problem and to improve its resource allocations. Over the long run, IRS must do further research to obtain data on how and why its compliance programs influence the willingness of people to properly assess and pay their income taxes. Such data are essential to optimally allocate available resources in a way that best stimulates voluntary compliance.

In the short run, IRS should give greater emphasis to reducing foregone tax revenue in allocating resources among and within its compliance programs. To do that, IRS needs accurate data on the cost and revenue yield of its compliance programs. Generally, it has data showing only "average" dollar yields. IRS' management information systems do allow measurements of yield "at the margin" for the examination program, but they do not provide marginal yield data for other compliance programs.

Although IRS' cost/yield data must be used with caution, we can state with some confidence that additional resources in various programs would provide average revenue yields that significantly exceed average cost. This is particularly true for accounts receivable, where additional resources would have a sizable immediate impact on revenue collections. Unfortunately, however, the shortfall in IRS' management information is such that neither IRS nor we can estimate accurately how much revenue will be secured through an increase in resources or which programs provide the best dollar return for each additional investment. No one knows where diminishing returns will make further resource investment uneconomic at the margin.

In addition to administrative changes, legislative actions are needed in selected areas. Attachment IV to my statement lists legislative and administration recommendations still open which would contribute to improved compliance and/or IRS efficiency.

MORE RESOURCES ARE NEEDED

Even though IRS can use its resources more efficiently and effectively, the magnitude of the compliance problem and the increase in both the number and complexity of return filings pose demands for IRS so great that program efficiencies, including optimal resource allocations among programs, will go only so far in protecting the tax system. In our view, an increase in IRS' resources is warranted. Such an increase, within reason, would not increase the Federal budget deficit. This is because IRS' compliance programs, on the average, generate tax revenue in amounts that far exceed the programs' cost. For example, the average-yield-to-cost ratio was 8:1 for examination of returns and 21:1 for working delinquent accounts in 1981, according to data compiled by IRS. Additional information on program cost/yield ratios is given in attachment V to my statement.

In the fiscal year 1982 budget request, the Administration originally proposed a staff level of 88,000 for IRS. Concerned that this resource level might not be adequate, the House Ways and Means Oversight Subcommittee held hearings in May 1981.

During those hearings, we stated that IRS resources were insufficient to meet the demands of a growing workload and the problem of deteriorating compliance.

As we suggested during those hearings, IRS provided, at the Subcommittee's request, estimates showing that substantial tax revenue gains could be achieved through relatively small increases in IRS' budget. After analyzing the data provided by IRS, the Oversight Subcommittee wrote the House Appropriations Subcommittee requesting that IRS' appropriation be increased by 1,500 additional staff years and $38 million. IRS estimated that with those additional resources, it could generate additional revenue totaling $275 million, a 7:1 yield ratio, and could answer 1 million additional taxpayer inquiries. The House Appropriations Subcommittee approved the suggested increase. The Senate Appropriations Subcommittee reduced the amount but still approved a resource level higher than the Administration had requested. However, because of subsequent Administration activities and the Congress' decision to let IRS operate under a continuing resolution, the actual resources made available to IRS totalled less than 85,000 positions.

If the Administration's request for supplemental appropriations is approved without change, IRS will realize about 85,400 average positions and about $2.6 billion in fiscal 1982. According to IRS estimates, these reduced resource levels will result in the lowest examination coverage ever, 1.58 percent; a huge accounts receivable inventory of 1.5 million accounts totalling $4.8 billion; and, the greatest Tax Court backlog ever, over 45,000 unresolved cases.

I would now ~~like to~~ specifically discuss the adequacy of IRS' fiscal year 1983 budget request. The request shows a staff level of 88,700 and $2.9 billion in planned expenditures. This represents an increase of about 3,300 average positions and $328 million above the estimated fiscal year 1982 levels--a 4 percent increase in staff years. However, it is also 50 staff years less than the lowest level initially approved by the House and Senate Appropriation Subcommittees for fiscal year 1982.

The fiscal year 1983 budget does reflect a shift in resources to a seriously underfunded program. IRS proposes to increase resources for delinquent accounts by 3,000 average positions over the fiscal year 1982 level. However, increases scheduled for examination are less than 1,000 positions, raising expected examination coverage by only .09 percent to 1.67 percent. And, with only modest increases in resources for some other programs, IRS will still be unable to keep pace.

The Administration proposes to substantially cut back on IRS' taxpayer assistance activities. Already, IRS has eliminated direct return preparation assistance at walk-in offices and, in total, it expects to provide assistance to 41.4 million taxpayers in fiscal year 1982, 3.4 million fewer than the 44.8 million served in fiscal year 1981. In fiscal year 1983, IRS expects to be able to provide assistance to only 19.4 million taxpayers as its taxpayer assistance staff year allocation declines from about 4,100 to 2,400.

Neither we nor IRS know who will be affected by the cutbacks or how the affected persons will react. We have initiated a major review of IRS' taxpayer assistance activities to obtain information on, among other things, the population groups IRS serves. Until we have completed our work, it is unlikely that the Congress will know which specific taxpayer groups will be most affected by proposed cutbacks. Once these groups have been identified, it may well be possible to better predict the actual effects of the proposed cutbacks.

Also, varying resource levels create a highly disruptive effect on the Service's operations. IRS was authorized about 87,500 staff years in fiscal 1980; 86,200 in 1981; and, 85,400 in 1982. The request for 1983 is 88,700. This racheting of staffing levels makes it extremely difficult to develop well-founded plans for acquiring, training, and focusing human resources on the multifaceted task of administering the tax system. A larger and more consistent level of resources to keep pace with growing demands on the tax system appears in order.

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While we know that the compliance problems with the Nation's tax system require attention, we cannot state precisely to which programs additional resources could be allocated to optimize use of all available resources. We do know, however, that additional resources in some programs will result in a large and immediate flow of tax revenue to the Treasury. These resources are not only justified by the potential revenue gains, but--of equal or more importance--by the need to cope with IRS' increasing workload due to decreasing voluntary compliance, increasing tax law complexity, and increasing taxpaying population.

There are fundamental questions of fairness and of taxpayers' perception which, we think, should also be kept in mind when considering IRS' budget request. Is it fair that the vast majority of taxpayers, despite these difficult economic times, manage to pay their proper share, while

--the returns of many taxpayers with high potential for tax change go unaudited,

--tax evasion goes uninvestigated, and

--unpaid taxes are written off?

Taxpayers' perceptions that others can get away with not complying jeopardizes the entire system. For example, one reason for the growth of the tax protester movement seems to be the apparent success of some protesters who manage to delay or completely avoid paying taxes.

In closing, let me set forth some considerations that the Congress should keep in mind in deliberating on the desirablility of providing IRS with more resources.

First, IRS' unique role should be recognized, and the agency should be treated separately on any initiatives aimed at paring the size of the Federal work force. The rest of Government can essentially be lumped together and characterized as the "expenditure side." With some minor exceptions, IRS stands alone on the "revenue side." Actions to cut the cost of Government and scale back the pervasive Federal presence should not be indiscriminately applied to this agency and its special mission.

Second, it is important to keep in mind that IRS' various compliance activities do no more than require citizens to pay those taxes that were properly due in the first place, and that in fact were so paid by most of their number. Effective compliance should not be viewed as representing a special burden to the public at large; rather it is aimed at ensuring that all share their fair burden.

Finally, with respect to the question at hand, namely how many additional resources should IRS be provided with, let me offer the following. There is no doubt that IRS can return in added revenue some multiple of the additional funds it is proided. The problem, however, is trying to identify the optimum application of any finite amount of such resources. Given the lack of available data for making optimum allocations, the best approach might be to ask IRS to come forward again with its informed judgment on how various incremental funding increases would be applied. For example, as before, Congress could task IRS with calculating the operational, revenue, and cost impacts of personnel gains of some staff-year increment, 500 for example, ranging up to perhaps a total increase of 5,000 people.

Let me caution, however, that the resources provided must be adequate for the agency to meet its basic management information needs, such as (1) the need for research to better understand how its activities affect voluntary compliance and (2) the need to develop a management information system that will provide the marginal cost/yield data necessary for developing a more scientific approach to making resource determinations and allocations.

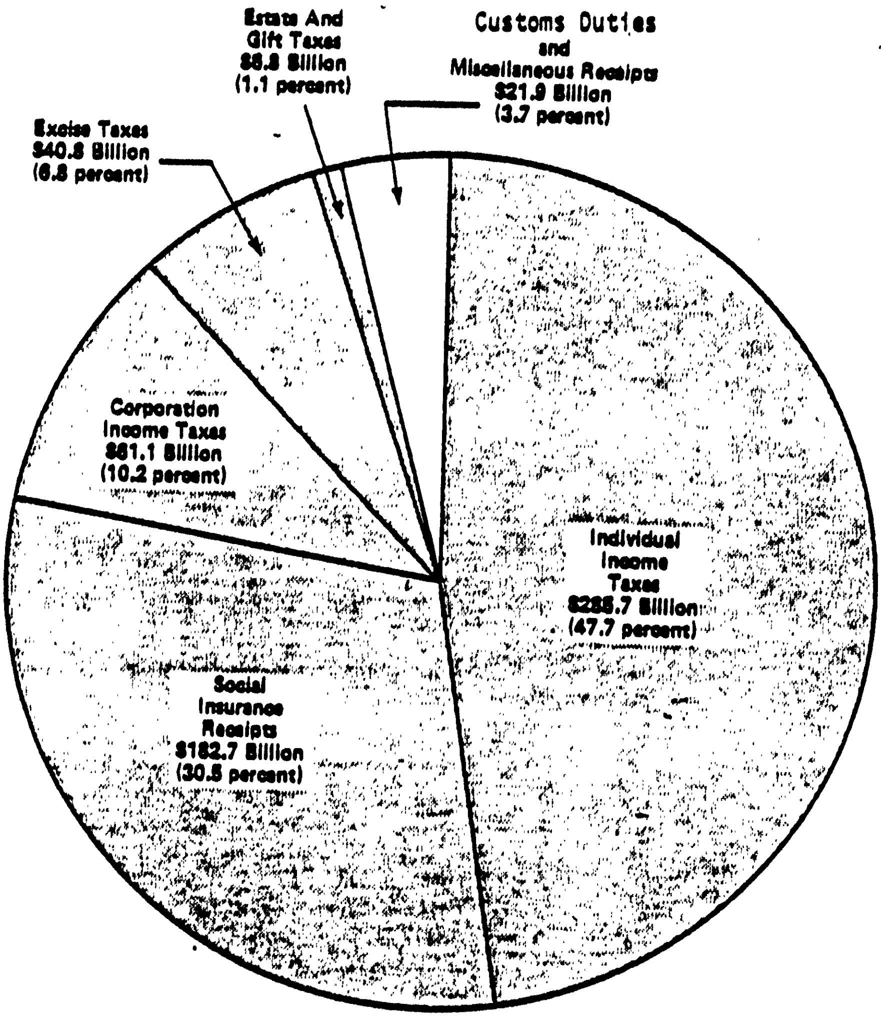
That concludes my prepared statement. I would be pleased to answer any questions.

ATTACHMENT I

ATTACHMENT I

**FEDERAL REVENUES**

Fiscal Year 1981 Actual



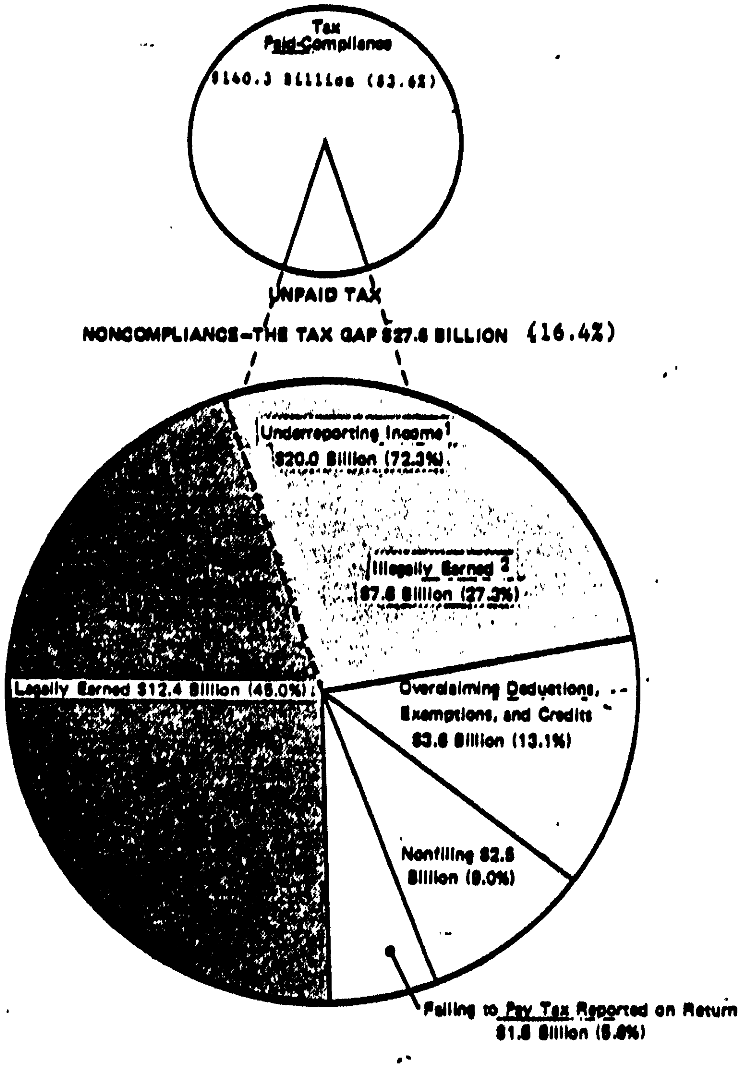

Shaded portion indicates collections made by IRS.

Note: This chart shows receipts only. It does not show that portion of the budget financed through borrowing. Also, a small portion of the excise tax collections is the responsibility of the Bureau of Alcohol, Tobacco and Firearms, Department of the Treasury

ATTACHMENT II

ESTIMATED INDIVIDUAL INCOME TAX OWED U.S. IN 1976

TOTAL $167.9 BILLION




[1] Excludes underreported income from nonfilers.

[2] Estimate includes only major criminal activity.

## IRS RESOURCES AND WORKLOAD BY PROGRAM
## FISCAL YEARS 1976, 1982, 1983

| Program | 1976 Workload (000) | 1976 Staff years (note a) | 1982 Workload (000) | 1982 Staff years | 1983 Workload (000) | 1983 Staff years (estimates) | Change 1976-83 Workload (percent) | Change 1976-83 Staff years (percent) |
|---|---|---|---|---|---|---|---|---|
| Examination (note c) | 123,361 | 28,164 | 128,264 | 27,882 | 130,422 | 28,764 | + 5.7 | + 2.1 |
| Collection accounts receivable | 614 inventory | 9,415 | 1,478 inventory | 10,774 | 705 inventory | 13,730 | + 14.8 | + 45.8 |
| Delinquent returns | 281 inventory | 1,849 | 724 inventory | 3,711 | 815 inventory | 4,091 | +190.0 | +121.3 |
| Returns compliance | 248 returns | 442 | 23 returns | 71 | 129 returns | 373 | - 48.0 | - 15.6 |
| Criminal investigation | 8.1 invest. | 4,090 | 5.7 invest. | 4,361 | 5.7 invest. | 4,361 | - 29.6 | + 6.6 |
| Information returns (note b) | 462,000 doc. rec. | 1,700 | 609,000 doc. rec. | 2,968 | 614,000 doc. rec. | 3,378 | + 32.9 | + 98.7 |
| Total IRS staff years | | 84,264 | | d/85,363 | | 88,673 | | + 5.2 |
| Total IRS appropriations | | $1,691,520 (000) | | d/$2,589,034 (000) | | $2,917,159 (000) | | +72.5 |

a/1976 staff years are not adjusted to reflect organizational shifts.

b/Information Returns is a multifunctional program and some of the staff years shown for that program are also included in the staff years for the other programs listed above.

c/Examination workload is prior calendar year filings.

d/Includes pending supplementals of 1,005 average positions and $123,483,000.



ATTACHMENT III

ATTACHMENT IV

ATTACHMENT IV

## OPEN GAO RECOMMENDATIONS TO THE CONGRESS AND IRS TO IMPROVE COMPLIANCE AND/OR IRS EFFICIENCY

| Congressional Recommendations | Source |
|---|---|
| 1. Impose mandatory withholding on agricultural employees. | B-137762 3-26-75 |
| 2. Repeal occupational taxes on the alcohol industry. | B-137762 1-16-76 |
| 3. Adopt standards for determining whether an individual is an employee or self-employed. | GGD-77-88 11-21-77 |
| 4. Revise educational expense deduction to clarify tax status of educational grants. | GGD-78-72 10-31-78 |
| 5. Consider ways of imposing a late filing charge on taxpayers due refunds who file late. | GGD-79-69 7-11-79 |
| 6. Revise the personal casualty and theft loss deduction. | GGD-80-10 12-5-79 |
| 7. Modify disclosure provisions of 1976 Tax Reform Act. | GGD-80-76 6-17-80 |
| 8. Modify summons provisions of 1976 Tax Reform Act. | GGD-80-76 6-17-80 |
| 9. Streamline legal review of criminal tax cases. | GGD-81-25 4-29-81 |
| 10. Amend the Bank Secrecy Act of 1970 to require reauthorization of reporting requirements. | GGD-81-80 7-23-81 |
| 11. Provide that IRS can require certain information from U.S. subsidiaries of foreign parent corporations. | GGD-81-81 9-30-81 |
| 12. Make pension plan determinations by IRS mandatory for tax qualification. | HRD-81-117 9-30-81 |

| Recommendations to the Commissioner of Internal Revenue (note a) | Source |
|---|---|
| 1. Improve programs to collect taxes withheld by employers. | GGD-78-14 2-21-78 |
| 2. Improve utilization of currency transaction reports. | GGD-79-24 4-6-79 |
| 3. Develop and use an ADP Cost Accounting System in IRS. | GGD-79-48 6-18-79 |
| 4. Develop more selective system for detecting and investigating nonfilers. | GGD-79-69 7-11-79 |
| 5. Establish a system to check delinquent returns for unreported income. | GGD-79-69 7-11-79 |
| 6. Improve the corporate audit selection system. | GGD-79-43 8-3-79 |
| 7. Increase use of computer audit techniques in all compliance programs. | GGD-80-33 1-24-80 |
| 8. Strengthen efforts to detect and pursue corporate nonfilers. | GGD-80-34 2-11-80 |
| 9. Simplify estimated tax forms and instructions. | GGD-80-89 7-16-80 |
| 10. Improve the selection system for traditional partnership returns. | GGD-80-98 9-5-80 |
| 11. Expand and improve the computer processing of information returns. | FGMSD-81-4 10-20-80 |
| 12. Monitor districts' efforts to get newspapers to publish lists of individuals entitled to undelivered refund checks. | GGD-81-71 4-10-81 |
| 13. Streamline legal review of criminal tax cases. | GGD-81-25 4-29-81 |
| 14. Establish working group in each district to handle protester and other special compliance cases. | GGD-81-83 7-8-81 |

a/As of March 1982, IRS had many of these recommendations at various stages of implementation.

| | | Source |
|---|---|---|
| 15. | Prepare substitute tax returns with information from other sources. | GGD-81-83 7-8-81 |
| 16. | Establish criteria on time allowed protesters before issuing a summons. | GGD-81-83 7-8-81 |
| 17. | Develop a more comprehensive management information system pertaining to illegal tax protester efforts. | GGD-81-83 7-8-81 |
| 18. | Develop and coordinate with Justice a plan for dealing with illegal tax protesters. | GGD-81-83 7-8-81 |
| 19. | Seek approval of the Joint Committee on Taxation to disclose taxpayer return information for certain tax protester cases. | GGD-81-83 7-8-81 |
| 20. | Consider ways to get a better measure of noncompliance with the requirements of section 482. | GGD-81-81 9-30-81 |
| 21. | Reassess IRS' criteria for requesting economists' participation in section 482 adjustments. | GGD-81-81 9-30-81 |
| 22. | Establish a procedure for communicating information among audit teams doing similar work | GGD-81-81 9-30-81 |
| 23. | Clarify the description of information that corporations should report concerning the sale/purchase of stock. | GGD-81-81 9-30-81 |
| 24. | Develop procedures to determine taxpayer filing compliance on pension payouts. | HRD-81-117 9-30-81 |
| 25. | Discontinue program of granting installment-agreements-by-mail without determining ability to pay. | GGD-82-4 11-5-81 |
| 26. | Develop a system for evaluating the effectiveness of the installment agreement program | GGD-82-4 11-5-81 |

YIELD/AVERAGE COST ESTIMATES

FOR SELECTED IRS PROGRAMS

FISCAL YEARS 1976 THROUGH 1983 (note a)

| | Fiscal year | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
| **Examination** | | | | | | | | |
| Yield | $4,447 | $4,084 | $4,994 | $4,863 | $6,317 | $6,688 | $8,475 | $9,576 |
| Cost | $ 601 | $ 632 | $ 675 | $ 720 | $ 780 | $ 836 | $ 882 | $ 935 |
| Yield/cost ratio | 7.4 | 6.5 | 7.4 | 6.8 | 8.1 | 8.0 | 8.4 | 10.2 |
| **Criminal investigations** | | | | | | | | |
| Yield | 8,797 | 8,361 | 8,733 | 8,700 | 7,114 | 6,608 | 6,543 | 5,659 |
| Cost | $ 100 | $ 105 | $ 121 | $ 130 | $ 154 | $ 151 | $ 141 | $ 171 |
| Cost per invest. | $11,367 | $12,558 | $13,855 | $14,942 | $21,647 | $22,851 | $21,550 | $30,217 |
| **Accounts receivable** | | | | | | | | |
| Yield | $3,492 | $3,069 | $3,315 | $4,900 | $6,000 | $5,384 | $6,379 | $7,792 |
| Cost | $ 179 | $ 188 | $ 201 | $ 213 | $ 219 | $ 255 | $ 295 | $ 399 |
| Yield/cost ratio | 19.5 | 16.3 | 16.5 | 23.0 | 27.4 | 21.0 | 21.6 | 19.5 |
| **Delinquency investigations** | | | | | | | | |
| Yield | $407 | $363 | $435 | $839 | $1,309 | $1,403 | $1,568 | $1,856 |
| Cost | $ 35 | $ 36 | (b) | $ 62 | $ 73 | $ 91 | $ 102 | $ 119 |
| Yield/cost ratio | 11.6 | 10.1 | (b) | 13.5 | 17.9 | 15.4 | 15.4 | 15.6 |
| **Returns compliance** | | | | | | | | |
| Yield | $133 | $138 | $126 | $21 | $18 | $14 | $6 | $54 |
| Cost | $ 8 | $ 10 | (b) | $ 6 | $ 6 | $ 4 | $2 | $11 |
| Yield/cost ratio | 16.6 | 13.8 | (b) | 3.5 | 3.0 | 3.5 | 3.0 | 4.9 |
| **Document matching** | | | | | | | | |
| Yield | $130 | (b) | $219 | $227 | $311 | $459 | $511 | $726 |
| Cost | $ 24 | $39 | $ 52 | $ 57 | $ 63 | $ 87 | $ 74 | $ 87 |
| Yield/cost ratio | 5.4 | (b) | 4.2 | 4.0 | 4.9 | 5.3 | 6.9 | 8.3 |
| **Math error** | | | | | | | | |
| Yield | $662 | $716 | $1,068 | $1,270 | $1,242 | $1,687 | (b) | (b) |
| Cost | (b) | (b) | (b) | (b) | (b) | (b) | (b) | (b) |
| Yield/Cost ratio | (b) | (b) | (b) | (b) | (b) | (b) | (b) | (b) |

a/Yield is measured in millions of dollars of net assessments except for the Criminal Investigations and the Accounts Receivable Programs. The Criminal Investigations Program is measured in total investigations; the Accounts Receivable Program in millions of dollars collected.

b/Data not readily available.

Senator GRASSLEY. I will ask the first question.

The General Accounting Office made the initial recommendation that no interest be paid on delinquent returns except for the period after filing. I note that you continue to support that recommendation.

Doesn't a similar concern with taxpayers' ability to play the system suggest that refunds from net operating loss carrybacks be subject to the same rule as under the bill?

Mr. ANDERSON. It would in the first instance, sir. I think there are some additional complexities involved in that. I would like to submit a response to that for the record, if I may.

Senator GRASSLEY. All right.

[Mr. Anderson's written response to a question by Senator Grassley follows:]

While we have an ongoing study of the quality of IRS' corporate audits, we have not done a significant amount of work specifically involving net operating loss carrybacks. It is our opinion, however, that there may be somewhat different considerations involved in disallowing interest for most delinquent taxpayers and for those taxpayers claiming net operating loss carrybacks. In this regard, we share the concerns outlined by the Treasury Department in its testimony with respect to taxpayers who, for valid business reasons, are unable to file their returns prior to the due date of the return for the loss year.

Senator GRASSLEY. Mr. Anderson, in your testimony you note that the General Accounting Office was the source of the idea for the minimum $100 penalty for nonfilers. Some have expressed the concern that this penalty will actually discourage taxpayers from filing late returns. Others, including the Treasury Department, have suggested such a minimum penalty is too onerous. How do you respond to those criticisms?

Mr. ANDERSON. One thing to keep in mind, sir, is that the penalty that we spoke of would apply to those instances where IRS had to go out and identify a nonfiling taxpayer. That would not be the case of a taxpayer voluntarily coming forward late and submitting a return. It would be where, as part of its taxpayer delinquency and other programs, IRS identifies a nonfiler, pursues that party, and gets them to submit a return. We see that as a separate situation and one deserving of a severe penalty.

Senator GRASSLEY. All right.

Some of our witnesses will testify before the day is out in support of extending withholding to low-compliance areas. In general our bill adopts expanded and improved information reporting requirements. What competing considerations should we balance when we evaluate the withholding versus increased information reporting with penalties?

Mr. ANDERSON. On the benefits side, sir, I would say that there is no doubt that withholding would stimulate greater compliance. I guess the two figures I would compare in saying that is the 97- to 99-percent compliance where we do have withholding in the wage area and the about 90-percent compliance that we have where information reporting is done without withholding. I think benefits would be there, definitely—added revenues.

On the disbenefit side, the adverse effects side, we would certainly be increasing the paperwork burden and the administrative burden on many payers who would be subject to the requirement. I think that if such legislation is finally formulated, it would have to set some thresholds that would make whatever effort is required by reporters to be cost beneficial to all concerned.

Senator GRASSLEY. Maybe it is axiomatic, but are you sure that reporting ends up with more paperwork for the business than the withholding?

Mr. ANDERSON. I see your point, sir. No; perhaps not. Very likely not.

Senator GRASSLEY. Or maybe you were speaking about the IRS?

Mr. ANDERSON. No; I was speaking from the standpoint of the payer. And your point is well taken.

I presume there would be some additional administrative tasks associated with this.

Senator GRASSLEY. But obviously you are saying that there is going to be more revenue coming in from the withholding, even if the paperwork is equal in either case?

Mr. ANDERSON. Absolutely, sir. Yes.

Senator GRASSLEY. Senator Dole.

Senator DOLE. Do you have about the same figures of losses as the IRS and Treasury? What is your 1982 number, for example? How much do we lose because people don't pay tax or don't pay what they should? Do you make any estimates?

Mr. ANDERSON. We do not make independent estimates, sir. No; to this point in time we have been relying primarily on IRS's taxpayer compliance measurement program, and its 1979 study which covered calendar year 1976. We have no independent study.

I can say that we kind of sense that any figure that is thrown out in this regard is far from precise, but it is an awful lot of money.

Senator DOLE. Was your recent investigation a limited investigation? Did you get into both the legal and the illegal sector of tax compliance?

Mr. ANDERSON. No; we did not, sir. Again, we are aware of what IRS says on the subject, and aware that the illegal aspect fortunately isn't that large a part of the overall problem.

Senator DOLE. But you didn't touch on the illegal aspect at all?

Mr. ANDERSON. We have touched on the illegal aspects in the course of other GAO work, sir. In other words, we have always said, for example, that the Racketeer-Influenced and Corrupt Organization Act, and the Continuing Criminal Enterprise Act provide means for getting to the assets of lawbreakers and organized crime, and we have always been critical of the efforts to date, at least, of agencies like the Drug Enforcement Administration and even the FBI to avail themselves of those statutes.

We have also in the past gone on record being critical of IRS's decrease in the amount of resources that were applied to major organized crime and drug dealers. It is a fact that there was a purposeful change in direction back in the early 1970's that has substantially reduced the amount of IRS resources that were devoted to pursuing criminals like that.

Senator DOLE. I note your last statement that you really haven't had a chance to review the legislation as much as you would like. But we do hope to work with your staff as we put together what we hope will be meaningful legislation.

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I suggest that if this is only a first step, as Senator Baucus correctly notes, what happens to all of the money we don't touch? I think that's the challenge of this committee. But at least we could pick up an estimated $8 billion if we pass the legislation that is before us without substantial change.

Mr. ANDERSON. Correct, sir.

Senator DOLE. We thank you.

Senator GRASSLEY. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Anderson, are you familiar with the general practice of waiters and waitresses in tip pooling and tip splitting?

Mr. ANDERSON. No; I am not, sir—not with any detail. No.

Senator BAUCUS. All right. I won't ask the question, then.

Senator GRASSLEY. Senator Chafee.

Senator CHAFEE. Mr. Anderson, I would like to repeat the statement that you made in the bottom of page 2: "Our Nation's tax system is not in as good health as it should be. There is a trend toward contempt and abuse of the system which seriously undermines the concept of voluntary compliance on which the system depends."

I must say that I agree with that wholeheartedly, that if noncompliance grows it will snowball and worsen. I, therefore, commend you for the points you made in your statement.

Now I would like to get back to this business of information reporting. As you know, last year we in Congress overwhelmingly rejected the idea of the withholding tax on interest. Yet, that idea is being advocated once again.

We already have information reporting which isn't used, and you are advocating more information reporting.

How do you reconcile this contradiction? We have information reporting on interest payments already—not on Federal debt and bearer obligations, but this information doesn't seem to satisfy the Government. They don't seem to match the information returns with the individual returns from the taxpayers?

Mr. ANDERSON. Good question, sir.

The figure that was cited by IRS today as an estimate of the tax gap for unreported and underreported dividends and interest was about, I think, $8.2 billion for 1981. I think it was interesting that they said that about 37 percent of that represented interest and dividend payments that were already covered under current information reporting requirements. So that 37 percent is the figure that you are speaking to. Here, IRS already gets information returns, and yet for some reason they are not able to collect that money.

It is a fact that we still don't have 100-percent matching of the information returns that do come to IRS. I think the latest figure I saw is that for fiscal year 1983 IRS proposes to convert about 25 percent of the paper returns to magnetic media and use for their system.

See, the problem is that a large part of the information returns that are coming in are still on paper, and IRS lacks the resources to convert them and use them in its programs. Therefore, I think it is selecting one or two letters of the alphabet—there is a name for that program.

Mr. TRISLER. The Alpha Sample.

Mr. ANDERSON. The Alpha Sample. They are converting four or five letters of the alphabet, of the paper returns that are submitted, and then using them for their audit work.

So, No. 1, they are not making complete matches on all of the information that is coming in. No. 2, even when they make a match, they really can't tell from the information that they are comparing whether that interest was or was not omitted on the return. It would have to be some grossly large figure in order to strike a signal.

So, more needs to be done in the processes for using the information that does come in.

Senator CHAFEE. All right. Now, how complicated is it for the Federal Government to do its reporting on bearer bonds or interest payments and Federal debt?

Mr. ANDERSON. I am not aware that that has been explored yet, sir. I don't know.

Senator CHAFEE. When you said only 37 percent of interest now comes in on information returns, the difference between 37 percent and 100 percent—a very substantial portion of that must be Government obligations; isn't it?

Mr. ANDERSON. Right, sir.

By the way, let me make one correction. What I said was that of the $8.2 billion in taxes on interest and dividend payments that is part of the tax gap, IRS said that 37 percent of that figure had been covered by existing information reporting requirements. I would venture to say that the amount of interest and dividend payments that is covered by information returns today is a figure I haven't seen IRS or anybody cite yet.

Senator CHAFEE. All right.

Now, the last question is to the point you made that perhaps we neglect here. It isn't just the U.S. Treasury in its general fund that is losing out. Social security must also be taking a licking through lack of reporting. That is, individuals aren't paying into the social security fund because an individual contractor, for example, not reporting income obviously isn't paying into the social security fund on that amount.

Mr. ANDERSON. Correct, sir. The only thing is that he wouldn't be getting the coverage either, assuming he is a nonfiler.

Senator CHAFEE. Well, he may have worked himself up to the necessary coverage in quarters, for example.

Mr. ANDERSON. Right.

Well, again, there is a maximum required for coverage, and he could do that. You are correct, sir.

Senator CHAFEE. Thank you.

Mr. ANDERSON. It is a problem, by the way, that we have spoken of in our reports. Right now you file a return and you get credit, as though you had paid the tax even though you may not have.

In fact, a number of these self-employed people are covered even though they haven't made payments to the fund. That's a separate problem.

Senator CHAFEE. I didn't understand that, but I'll wrestle with that later.

Senator GRASSLEY. There are no further questions, Mr. Anderson. I want to thank you and your staff for coming to help us on this legislation.

Mr. ANDERSON. Thank you, sir. A pleasure.

Senator GRASSLEY. Our next panel consists of two people, Mr. Robert Parker, Chief of the National Income and Wealth Division, Department of Commerce; and Mr. Vito Tanzi, economist, International Monetary Fund, Washington, D.C.

Senator DOLE. I might say, while they are taking their places, that we hope to have the independent contractor bill drafted for introduction sometime later this week. We would be interested in having cosponsors. It has been worked out at the staff level, and we think it has potential.

Senator GRASSLEY. I will call on you, Mr. Parker. If you would start, please.

Could I also ask you, if it's possible, to summarize your statement, because it is normal procedure for us to have the entire statement printed in the record.

## STATEMENT OF ROBERT PARKER, CHIEF, NATIONAL INCOME AND WEALTH DIVISION, DEPARTMENT OF COMMERCE, WASHINGTON, D.C.

Mr. PARKER. Mr. Chairman, my statement is only a few minutes, so perhaps I will read it in its entirety.

I have been invited to appear before this committee to discuss the relationship between the Bureau of Economic Analysis' measure of personal income and corresponding estimates prepared by the Internal Revenue Service based on adjusted gross income as reported on individual tax returns.

Personal income is a component of the National Income and Product Accounts which are prepared by the Bureau of Economic Analysis. These accounts are designed to present in an integrated fashion a picture of the Nation's economic process. These accounts not only provide the gross national product and other measures of output but also information on the distribution of this output to the groups that determine the workings of the economy.

The Personal Income and Outlay Account is designed to focus on the activities of persons and to present information on the sources and disposition of their earnings. The sum of these earnings is personal income, which is defined as the income received by persons from all sources: Participation in production, transfer payments from Government, and Government interest.

Persons in the National Account consist of individuals, nonprofit institutions, private noninsured welfare funds and private trust funds.

To prepare the estimates of personal income we use a variety of sources, the most important of which include Bureau of Labor Statistics' tabulations of wages and salaries of employees covered by State unemployment insurance, Department of Agriculture estimates of farm income, Internal Revenue Service tabulations of corporate and noncorporate income tax returns, Census Bureau annual housing surveys, and Federal Budget and financial reports or transfer programs.

Another source of income earned by persons is the adjusted gross income item reported on IRS form 1040. Tabulations of these returns are prepared by the Internal Revenue Service and published in Statistics of Income. However, as the previous listing indicates, we do not make extensive use of these data. Where we do use these data, primarily for nonfarm self-employment income, the data are adjusted to take into account unreported income identified by various audit programs.

There are many reasons why BEA does not make more use of the IRS data: Several components of personal income are not included in AGI because the income is not taxable. Examples of such income are nontaxable transfer payments, employer contributions to private welfare funds, and income earned by certain low-income individuals. In addition, the IRS audit programs have identified substantial noncompliance for many types of adjusted gross income.

BEA has independently observed this compliance problem in two ways. First, we have prepared and published tables in which the personal income estimates are adjusted to the same definitional basis as adjusted gross income. This process, however, does not fully reconcile the two measures, and a difference or gap remains. This gap, which shows that the BEA measure of income is much larger than the corresponding IRS measure, consists of income not reported on the individual income tax returns, income earned by low-income individuals who are not required to file returns, errors and omissions in the items used to adjust personal income, as well as in the total income numbers. It appears that the first of these reasons, noncompliance, is the most important source of understatement in the IRS data.

The two tables which are attached to my presentation summarize the results of these comparisons and show that the gap is slightly over $100 billion in 1978 and that the largest components are interest income and proprietors' income.

Let me add that this gap, unlike the gap in the presentation by Mr. Egger, refers to gross income and not to tax revenue.

The second way in which we have observed that there is a reporting problem with the individual tax returns relates to the methods we use to estimate GNP. We estimate GNP by two independent methods: One in terms of products, the other in terms of income. The difference between these two measures is what we call the "statistical discrepancy." At present it is very small, less than a billion dollars.

If we were to use the IRS estimates of income as presently published, we would have a large discrepancy, and that would indicate that our national accounts were substantially out of balance. Therefore, to maintain the quality and consistency in our accounts, we only make minimal use of the IRS estimates. This minimal use also explains why we say that the shortfall in income reported to IRS does not translate into a shortfall in our measures of gross national product.

That concludes my statement, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF
ROBERT P. PARKER, CHIEF, NATIONAL INCOME AND WEALTH DIVISION
BUREAU OF ECONOMIC ANALYSIS
U.S. DEPARTMENT OF COMMERCE

Mr. Chairman, I have been invited to appear before this Committee to discuss the relationship between the Bureau of Economic Analysis measure of personal income and corresponding estimates prepared by the Internal Revenue Service based on adjusted gross income as reported on individual income tax returns.

Personal income is a component of the National Income and Product Accounts of the United States, which are prepared by the Bureau of Economic Analysis (BEA). These accounts are designed to present in an integrated fashion a picture of the Nation's economic process--i.e., the production, distribution, and uses of output. These accounts not only provide the Gross National Product (GNP) and other measures of total output, but also information on the distribution of this output to the groups that determine the working of the economy. The personal income and outlay account is designed to focus on the activities of persons and to present information on the sources and disposition of their earnings. The sum of these earnings is personal income, which is defined as the income received by persons from all sources, that is, from participation in production, from transfer payments from government and business, and from government interest. Persons in the national accounts consist of individuals, nonprofit institutions, private noninsured welfare funds, and private trust funds.

To prepare the estimates of personal income, BEA uses a variety of sources, the most important of which include Bureau of Labor Statistics tabulations of wages and salaries of employees covered by State unemployment insurance, Department of Agriculture estimates of farm income, Internal Revenue Service (IRS) tabulations of corporate and noncorporate income tax returns, Census Bureau Annual Housing Surveys, and Federal budget and financial reports of transfer programs.

Another source of income earned by persons is the adjusted gross income (AGI) item reported on IRS form 1040. Tabulations of these returns are prepared by IRS and published in Statistics of Income. However, as the previous listing of sources indicates, BEA does not make extensive use of these IRS data . Where BEA does use these data, primarily for nonfarm self-employment income, BEA adjusts the published IRS estimates to take into account unreported income identified by audit programs.

There are many reasons why BEA does not make more use of the IRS data. There are several components of personal income that are not included in AGI because the income is not taxable. Examples of such income are nontaxable transfer payments and employer contributions to private welfare funds, and income earned by certain low-income individuals. In addition, IRS audit programs have identified substantial noncompliance for many types of AGI.

BEA has independently observed this reporting problem in two ways. First, BEA has prepared and published tables in which the personal income estimates are adjusted, as much as possible, to the same definitional basis as AGI. This process, however, does not fully reconcile the two measures and a difference or "gap" remains. This gap, which shows that the BEA measure of AGI is much larger than the IRS measure, consists of income not reported on the individual tax returns, income earned by low-income individuals who are not required to file returns, errors and omissions in the BEA estimates of the items used to adjust personal income to the AGI concept, and errors in the estimates of total personal income and AGI. It appears that the first of these reasons--noncompliance--is the most important.

The first of the two attached tables presents the published results of the comparison of the period 1976-1978. The second table, published more recently, presents the gap distributed by type of income. Briefly, these tables show that the gap was slightly over $100 billion in 1978, compared with $23 billion in 1947, and that in 1978, interest income and proprietors' income had the largest gaps. The second way in which BEA has observed reporting problems with the individual income tax returns relates to the method used to estimate GNP. GNP is measured by two basically independent methods. GNP is measured as the sum of products--defined as final sales, which consists of sales to consumers, gross private domestic fixed investment, sales to governments, and net sales to foreigners, and inventory change. GNP also is measured as the sum of incomes generated in production, where production is equal to the cost of production plus profits. The costs include compensation of employees, net interest, depreciation, and indirect business taxes. Many of these costs, plus the profits of the self-employed, are components of personal income.

In the United States, GNP is obtained from the sum of the products approach. The difference between the product and income approaches is called the statistical discrepancy and provides an indication of the consistency of the GNP estimates. This discrepancy is very small; in the past 2 years it has been less than one billion dollars. However, if BEA were to use the AGI data to prepare its income estimates, there would be a substantial statistical discrepancy because the income-based estimate of GNP would be lower than the product measure by some high percentage of the AGI gap. Consequently, to maintain quality and consistency in our national accounts, BEA makes only minimal use of the AGI estimates. This minimal use explains why BEA says that a shortfall in income reported to IRS does not translate into a shortfall in GNP.

**Table 8.13.—Comparison of Personal Income in the National Income and Product Accounts (NIPA's) with Adjusted Gross Income as Published by the Internal Revenue Service (IRS)**

[Millions of dollars]

| | Line | 1976 | 1977 | 1978 |
|---|---|---|---|---|
| Adjusted gross income, IRS | 1 | 1,053,894 | 1,158,492 | 1,302,189 |
| Plus: Portion of personal income not included in adjusted gross income | 2 | 354,438 | 394,646 | 437,276 |
| Transfer payments except taxable military retirement and taxable government pensions | 3 | 175,213 | 126,281 | 193,039 |
| Other labor income except fees | 4 | 74,822 | 87,892 | 100,823 |
| Imputed income in personal income | 5 | 40,241 | 43,077 | 50,429 |
| Investment income retained by life insurance carriers and noninsured pension funds | 6 | 22,140 | 26,280 | 30,067 |
| Investment income received by nonprofit institutions or retained by fiduciaries | 7 | 10,312 | 11,623 | 13,029 |
| Differences in accounting treatment between NIPA's and tax regulations, net | 8 | 6,692 | 11,307 | 12,560 |
| Other personal income exempt or excluded from adjusted gross income | 9 | 25,018 | 28,193 | 31,291 |
| Less: Portion of adjusted gross income not included in personal income | 10 | 95,268 | 106,123 | 120,237 |
| Personal contributions for social insurance | 11 | 55,485 | 61,108 | 69,644 |
| Net gain from sale of assets | 12 | 18,717 | 21,361 | 23,329 |
| Taxable private pensions | 13 | 15,699 | 18,913 | 21,614 |
| Small business corporation income | 14 | 1,876 | 1,973 | 2,471 |
| Other income in adjusted gross income but not in personal income | 15 | 3,391 | 2,770 | 3,119 |
| Plus: Difference between BEA and IRS measures of adjusted gross income [1] | 16 | 78,226 | 91,002 | 100,523 |
| Equals: Personal income NIPA's | 17 | 1,391,192 | 1,538,017 | 1,721,751 |

[1] Consists of income earned by low-income individuals who are not required to file income tax returns, unreported income identified by IRS audit programs that is included in the NIPA measure, and gross errors and omissions in lines 2 through 15. Also includes the net effect of errors in the IRS adjusted gross income (line 1) and NIPA personal income (line 17) measures. Such errors can arise from the sample used by IRS to estimate line 1 and from the data sources used by BEA to estimate line 17.

**Table 5.—Adjusted Gross Income Gap; Total and by Type of Income, 1947–78**

[Billions of dollars]

| Year | BEA-derived AGI | AGI of IRS | AGI gap | Wages and salaries | Pensions and annuities | Farm proprietors' income | Nonfarm proprietors' income | Personal dividend income | Rental income of persons | Personal interest income |
|---|---|---|---|---|---|---|---|---|---|---|
| 1947 | 172.7 | 149.7 | 23.0 | 4.2 | 0.3 | 10.6 | 1.9 | 1.4 | 2.7 | 1.8 |
| 1948 | 184.7 | 163.5 | 21.1 | 5.5 | .3 | 9.1 | 2.1 | 1.4 | 2.9 | 1.9 |
| 1949 | 184.0 | 162.6 | 21.4 | 6.5 | .2 | 7.8 | *2.0 | 1.4 | 2.4 | 2.1 |
| 1950 | 202.7 | 179.1 | 23.6 | 5.5 | .3 | 6.6 | 4.3 | 2.0 | 2.6 | 2.4 |
| 1951 | 229.2 | 202.3 | 26.9 | 6.6 | .4 | 7.9 | 4.6 | 1.8 | 2.9 | 2.7 |
| 1952 | 241.9 | 215.3 | 26.6 | 6.0 | .4 | 7.2 | 5.1 | 1.9 | 2.1 | 2.8 |
| 1953 | 256.7 | 229.7 | 27.0 | 6.3 | .5 | 6.8 | 5.7 | 2.1 | 2.2 | 2.6 |
| 1954 | 254.9 | 229.2 | 25.7 | 6.4 | .6 | 3.3 | 6.0 | .8 | 2.2 | 4.4 |
| 1955 | 275.0 | 246.5 | 28.5 | 6.7 | .7 | 4.1 | 5.8 | .9 | 2.1 | 5.1 |
| 1956 | 295.4 | 267.7 | 27.7 | 5.4 | .9 | 4.4 | 4.6 | .8 | 2.9 | 5.7 |
| 1957 | 308.1 | 280.3 | 27.7 | 6.8 | 1.0 | 3.5 | 6.1 | .6 | 2.1 | 6.7 |
| 1958 | 312.8 | 281.2 | 31.6 | 8.4 | 1.1 | 4.7 | 6.3 | .7 | 3.3 | 7.2 |
| 1959 | 336.2 | 305.1 | 31.1 | 6.9 | 1.4 | 4.4 | 6.3 | .9 | 3.6 | 7.6 |
| 1960 | 348.1 | 315.6 | 32.7 | 8.1 | 1.6 | 5.0 | 5.8 | 1.3 | 2.9 | 8.0 |
| 1961 | 360.4 | 329.9 | 30.6 | 6.6 | 1.8 | 4.6 | 6.3 | 1.1 | 2.8 | 7.6 |
| 1962 | 380.7 | 348.7 | 32.0 | 8.0 | 1.9 | 4.3 | 5.5 | 1.4 | 2.6 | 8.4 |
| 1963 | 400.8 | 368.8 | 32.0 | 6.9 | 2.0 | 4.6 | 5.6 | 1.5 | 3.0 | 8.3 |
| 1964 | 434.0 | 396.7 | 37.3 | 8.7 | 2.4 | 4.9 | 6.2 | 2.2 | 3.5 | 9.6 |
| 1965 | 467.3 | 429.2 | 38.1 | 7.0 | 2.7 | 4.5 | 6.2 | 2.6 | 4.1 | 11.1 |
| 1966 | 512.9 | 468.5 | 44.4 | 11.6 | 3.0 | 5.9 | 6.6 | 1.8 | 3.5 | 11.8 |
| 1967 | 546.2 | 504.8 | 41.4 | 8.0 | 3.5 | 3.9 | 6.9 | 2.1 | 3.7 | 12.3 |
| 1968 | 569.9 | 524.4 | 45.5 | 11.1 | 3.4 | 4.9 | 6.4 | 2.5 | 3.9 | 13.2 |
| 1969 | 652.7 | 603.5 | 49.2 | 9.5 | 4.0 | 6.3 | 7.8 | 2.3 | 4.3 | 14.8 |
| 1970 | 686.1 | 631.7 | 54.4 | 10.2 | 5.0 | 6.5 | 8.6 | 1.9 | 4.4 | 17.8 |
| 1971 | 730.6 | 673.6 | 56.9 | 10.2 | 5.9 | 6.6 | 9.4 | 2.5 | 4.5 | 17.6 |
| 1972 | 805.3 | 716.0 | 89.4 | 7.2 | 6.9 | 8.5 | 10.6 | 2.7 | 4.7 | 17.8 |
| 1973 | 901.4 | 827.1 | 74.3 | 10.5 | 7.3 | 14.5 | 11.6 | 2.9 | 5.7 | 21.6 |
| 1974 | 978.6 | 905.5 | 73.1 | 1.7 | 7.9 | 15.3 | 13.6 | 3.0 | 6.3 | 23.1 |
| 1975 | 1,019.6 | 947.8 | 71.8 | 4.2 | 8.9 | 9.7 | 14.9 | 2.7 | 6.6 | 24.9 |
| 1976 | 1,132.1 | 1,053.9 | 78.2 | 2.8 | 10.4 | 10.1 | 19.2 | 6.0 | 5.0 | 25.7 |
| 1977 | 1,250.7 | 1,158.5 | 92.2 | 7.6 | 10.9 | 9.4 | 20.4 | 5.0 | 7.7 | 31.1 |
| 1978 | 1,406.0 | 1,302.4 | 103.5 | 7.0 | 13.1 | 13.8 | 20.5 | 5.8 | 7.8 | 35.5 |

Sources: table 8.13, "National Income and Products, 1976-79", Special Supplement to the July 1981 Survey of Current Business

table 5, "Relationship Between Personal Income and Adjusted Gross Income, 1947-78", November 1981 Survey of Current Business

Senator GRASSLEY. Thank you.
I will go on to you, Mr. Tanzi, before we ask questions.

STATEMENT OF VITO TANZI, DIRECTOR, FISCAL AFFAIRS DEPARTMENT, INTERNATIONAL MONETARY FUND, WASHINGTON, D.C.

Mr. TANZI. Thank you, Mr. Chairman.

I will summarize very briefly the statement. I was asked to give a background statement on the underground economy, and I am going to cover just four different questions.

First, very briefly I will define what the underground economy is. Second, I want to discuss whether this is something new, a new phenomenon, or whether it is something that has been around for some time. Third, I will say a few words about its size and rate of growth. And, fourth, I will say a few things about its implications for tax revenue.

In much of the discussions of the underground economy it is rarely stated clearly whether people mean underground vis-a-vis tax purposes or vis-a-vis national accounts. As Mr. Parker just stated, they can be two different phenomena. One can underreport income to the tax authority, but this income could be totally measured by the national accounts authorities.

So in some of the statements when people refer to the impact of that underground economy on the rate of growth of the country or unemployment, they are really talking about the national accounts measure rather than the tax measure.

I suppose that, from the point of view of this subcommittee, you are interested more in the underreporting to the tax authorities rather than in the underestimation of the national income accounts.

The second question to which I want to refer is whether this is something new. I have done a considerable amount of work in this area, and my judgment, which maybe is not shared by most of the speakers today, is that it is nothing new. There are some estimates for the Second World War or for the periods before that which would indicate that the underground economy was as large and perhaps even larger at that time than it is today. And, for sure, if it is related to the marginal tax rate, the marginal tax rate was higher, for example, in 1938 and 1940 than today. So, from this point of view, there is no reason why it should not have been higher at that time. And if it is related to restrictions on economic activities, well, there was prohibition, and there were lots of restrictions during the Second World War. So, again, there is no reason why underground activities should not have been higher.

Going to the third question—how large it is—again here I want to inject a note of skepticism. It's very unlikely that we will ever know how large this underground activity is. If it could be observed and measured, then it would not exist. Therefore, much of the evidence that we have is really circumstantial and indirect.

We have some evidence from anecdotes, we have some direct measurements from the Internal Revenue, and we have some measurements from monetary statistics. Anecdotes normally exaggerate this. You could have lots of reports of dentists who are paid in cash, and still this might not represent a very large amount of gross national product.

For example, if everybody spent 10 percent of gross national product for payment to underground activities, this would come to about $5,000 per family with four members. I doubt that too many people would believe that a family of four is spending as much as $5,000 on underground economic activity.

Well, in terms of rate of growth, again there is very little evidence that this activity has been growing. There is some evidence since 1978, but I have just listened this morning to the statement by the Internal Revenue Service—and I have not seen the new report, so I am not sure how it relates to the earlier one—but from the evidence that I have seen it does not clearly indicate that this is a fast growing sector.

Just one last question I want to deal with is how relevant it is to tax figures.

Quite clearly there is lots of understatement in payment of taxes, and if this activity could be monitored better, then higher payment could come about. I firmly believe the figure I heard from the subcommittee about how much money could be contributed over the next 3 years from this source, but the figures of $50 or $60 or $70 billion which are shifted around—I simply don't believe those.

I would just want to summarize, saying that if certain things were done, clearly this problem would to a large extent become less serious: First, the tax system should clearly be simplified.

Maybe I should mention the fact that I am the author of two books on income taxation, and I spend my life advising foreign countries on their tax systems, and I still have difficulties in preparing my income tax returns.

So when the tax system reaches that point, we do have a problem. Simplification would go a long way.

Second, marginal tax rates should be reduced.

Third, auditing activity would go a long way to help in this.

Fourth, clearly, if the tax administrators need more revenues to do their job properly, they should be given.

Maybe I have summarized a little bit too much, but thank you.

[The prepared statement follows:]

Statement by Vito Tanzi,
Director of the Fiscal Affairs Department, International Monetary Fund,
before the Sub-Committee on Oversight of the Internal Revenue Service of
the Senate Finance Committee

Monday, March 22, 1982

I appreciate the opportunity to appear before the Sub-Committee on Oversight of the Internal Revenue Service to discuss the underground economy in the United States. I wish to emphasize at the beginning that I am appearing not in my official capacity as an employee of the International Monetary Fund, but as the author of various works on the underground economy. The views that I am expressing are therefore strictly personal ones, as the International Monetary Fund does not have any official position on this subject. What I would like to do in the short time assigned to me is to deal briefly with the following questions: (1) What is the underground economy? (2) Is it a new phenomenon or just a newly-discovered one? (3) What do we know about its size and rate of growth? (4) What are its implications for tax revenue?

As to the first question, current discussions of the underground economy have rarely emphasized that there are two distinct definitions of the underground economy, both of which are important but which, to a large extent, address different issues. The underground economy can be defined as the value of economic activities which, according to current convention, should be measured by the national accounts authorities, but which for a variety of reasons are not. In other words, what share of the real gross national product (GNP) is not picked up by the national accounts authorities or, alternatively, by how much is the official estimate of GNP lower than the real one. This is the definition relevant for economic policy and is one that has been emphasized by authors who have claimed that the national accounts underestimate employment, growth, and perhaps overestimate inflation rates. Alternatively, the underground economy can be related to incomes that should be reported to the tax authorities but, because of evasion, are not. This second definition is one relevant for the assessment of tax revenues and for answering the question of what reduction in the U.S. fiscal deficit could be achieved by a more intensive scrutiny of these activities. These two concepts are not necessarily related. For example, incomes may be measured by the national accounts authorities, while at the same time they may not be reported to the tax authorities. The reverse is also possible, although probably less likely. This distinction has not been given the importance that it merits, and the confusion between the two concepts has made difficult the comparison of estimates of the underground economy obtained by different authors. I shall assume that the tax concept is the one of interest in these hearings.

Let me now go to the second question of whether or not this is a new phenomenon. In my judgment, this is a phenomenon that has finally been discovered but it is definitely not new. Some time, over the past three or four years, it started attracting the attention of the news media and this led people to believe that they were witnessing something new, but obviously underground economic activities have been around since organized society came into existence. They are important all over the world and, in my judgment, it is likely they were more important in the past in the United States than they are today. There is, for example, considerable evidence that these activities flourished at least up to the 1940's, stimulated by prohibition, by the introduction of high marginal tax rates in the late 1930's, by the war, etc.

Let me turn now to the third question of how large is the underground economy in the United States. The most honest answer to this question is that nobody really knows, and it is unlikely that we will ever know for sure. This is so because many activities exist just because they cannot be monitored. If they could be monitored, so that they could be measured, they would no longer exist. We have at the moment three different kinds of evidence on which "estimates" have been based. One evidence is provided by anecdotes; the second is based on some direct attempts at measuring the underground economy; and the third is based on indirect measures, often relying on monetary statistics.

Anecdotes often reported in newspapers cannot possibly provide an estimate of the underground economy. As I indicated earlier, this is a phenomenon that has come of age, and for that reason is attracting attention as if it were something new. Estimates can be easily exaggerated. Let me give you an example. In 1982 the per capita GNP of the United States will be around $13,000; therefore, it would come to about $52,000 for a family of four. If the underground economy were 10 per cent of GNP, a figure considered very conservative by some authors, it would imply that the average family of four would spend more than $5,000 a year on underground activities. I, for one, find this figure hard to believe. I would suggest that you ask yourself whether, in your experience, the people that you know are spending this much money a year on underground activities. Even an estimate of 5 per cent of GNP already implies an average expenditure of about $2,500 for a family of four, hardly a small amount. The point I want to make is that it is possible to have a lot of anecdotal evidence of underground activities without getting too large a share of GNP.

Besides anecdotes, what other evidence do we have? Essentially, as I have already mentioned, we have attempts at direct measurements as well as indirect approaches. You are familiar with estimates by the Internal Revenue Service, so I will not discuss them. Some other direct estimates that I have seen would be of the same order of magnitude. Aside from the direct measures, we have an indirect measure based on monetary statistics. The estimates that are so derived have ranged from about 5 per cent to over 30 per cent of GNP. My own work supports the lower estimate in that range. I do not feel too strongly about my own estimate, but I do believe that some of the others I have seen are widely exaggerated. Furthermore, my own work does not support the contention that the underground economy has been growing in the United States, or at least it does not up to about 1978, after which time there is some evidence of growth.

Even 5 per cent of GNP implies an underground economy of about $150 billion. If these activities were all subject to all the taxes to which the reported activities are subject, they would generate up to about $50 billion in additional revenue. However, if they were subject to just income taxes, they could generate about $15 billion. In my judgment, both of these figures exaggerate the possibilities. The reasons are the following: (a) many underground activities would not be taxable because of the low income of the recipients; (b) many would simply not take place if discovered and taxed; and (c) many could never be reached by the tax authorities; or, alternatively, (d) many could be reached only at very high social as well as economic costs. Does it mean that no attempt should be made to check these activities? My answer is definitely not at all! The Government has a strong obligation to reduce tax evasion and this will happen if (a) the tax system is simplified; (b) marginal tax rates are kept at a moderate level by broadening the tax bases; (c) auditing activities are increased; and (d) the tax administrators are given the resources that they need. All of these changes would bring about some increases in tax revenues. However, I still have to find a country where very large increases have come about, at least in the short run, from administrative changes.

Senator GRASSLEY. I have a couple of questions. To some extent they are a little bit repetitive of what you have already spoken to, but I want to nail the fact that you have indicated that your estimates of unreported incomes are lower than many other people who have estimated unreported income.

Nevertheless, is it accurate to characterize your results as showing a substantial growing problem and one that this Congress ought to address as we seek to narrow budget deficits?

Mr. TANZI. Well, it is a serious problem, I think. I think that even the lowest estimate would indicate that maybe up to $150 billion is not being reported.

So the question that one has to ask is to what an extent better administrative measures would capture that? In my judgment much of this activity would simply disappear if we increased enforcement—for example, all the drug area. If this activity could be checked, probably it would no longer exist.

In other words, going from the amount of underreporting to the amount of taxes that could be recovered, there is a basic problem there. I believe we could recover $10 billion more a year and maybe even $15 billion. But once you begin to go beyond that, I begin to have serious problems.

Senator GRASSLEY. Your statement indicates that your estimates show some growth in noncompliance since 1978. Can you give us some idea of the extent of that growth, and do you have any explanation for the growth?

Mr. TANZI. Well, yes, there is an obvious explanation. Up to about that time the marginal tax rate had been periodically reduced, so that by and large it had not increased very much. But after 1978 there was a substantial increase in marginal tax rates. Those are the main reasons for the underground economic activity, and that would be an obvious explanation.

In terms of the answer to your other question, I find that it may have grown by about 1 percentage point of gross national product between 1978 and the present time, which would imply about $30 billion, say.

Senator GRASSLEY. Senator Dole.

Senator DOLE. I may perhaps have some questions for Mr. Parker and Mr. Tanzi in writing, but I'll not take the time now.

Senator GRASSLEY. All right.

I should remind you that other members who are not here may have questions to submit to you in writing. We would appreciate your response to them.

I thank you very much for your participation.

I would call the next panel of Donald Alexander, Fred Hickman, and Jack Nolan. Donald Alexander is currently a lawyer in private practice in Washington, D.C.; and Mr. Alexander was Commissioner of Internal Revenue from 1973 to 1977.

Mr. Hickman is currently a lawyer in private practice in Chicago. Mr. Hickman was Assistant Secretary of the Treasury for Tax Policy under President Ford.

Mr. Nolan is currently Chairman of the Tax Section of the ABA. Mr. Nolan was Deputy Assistant Secretary of the Treasury for Tax Legislation under President Nixon.

I will ask you to each respond with your statement in the order that I introduced you, and I would also ask you to please summarize your statement so that we will have time for questioning.

## STATEMENT OF DONALD C. ALEXANDER, ESQ., WASHINGTON, D.C.

Mr. ALEXANDER. Thank you, Mr. Chairman.

I am Donald Alexander, appearing here purely in my personal capacity and not on behalf of anybody. In fact, after I finish talking I may not have any clients.

I do not have a statement, Mr. Chairman. Thanks to various commitments, I was unable to put one together. I would like to file a letter for the record, with your permission, sir.

Senator GRASSLEY. Yes; we will do that in our normal procedure.

[The letter follows:]

MORGAN, LEWIS & BOCKIUS
COUNSELORS AT LAW
1800 M STREET, N. W.
WASHINGTON, D. C. 20036
TELEPHONE (202) 872-5000

PHILADELPHIA
NEW YORK
LOS ANGELES

MIAMI
HARRISBURG
LONDON

April 6, 1982

DONALD C. ALEXANDER
DIAL DIRECT (202) 872-5045

Hon. Charles E. Grassley
Chairman, Subcommittee on Oversight of
 the Internal Revenue Service
Senate Finance Committee
Room 2227, Dirksen Senate Office Building
Washington, D. C.

Dear Senator Grassley:

The purpose of this letter is to supplement my testimony before you on March 22, 1982 in support of broadened and strenthened withholding of income tax.

I was surprised that one member of our panel devoted five pages of his statement to an attack upon any extension of withholding, particularly with respect to dividends and interest, and a contention that information reporting is preferable to withholding. In my judgment, the opposite is the case.

I think we all agree that our present system of a broad-based, high-yield income tax could not survive without withholding upon wages and salaries, the major components of our income tax base. The panelist made the novel suggestion that withholding is not effective unless it results in a rough match of a person's actual tax obligation. This is without foundation. In the first place, withholding on wages and salaries does not result in such a match. Last year, over 71 million filers of Forms 1040 and 1040A were overwithheld by over $40 billion. Conversely, for many highly-compensated individuals wage withholding is inadequate to meet their tax responsibilities with respect to their earnings.

More important, a match is not a necessary ingredient to withholding as a means of greatly improving compliance. In my testimony, I mentioned the Treasury's recent statement in opposition to a current legislative effort to repeal withholding upon gambling winnings. The Treasury's statement explains the great advantages of withholding as compared with information reporting and, apart from the "10 percenter" aspect, <u>all</u> of these advantages are present in the extension of withholding to other types of income:

> Secondly, it must be recognized that withholding is an important tool available to the Internal Revenue Service to insure compliance in the reporting of income. Withholding is an element in improving compliance in two respects. First, it provides an incentive for taxpayers who have substantial winnings to report those

winnings accurately in order to claim the benefit of the withheld amounts on their income tax returns. Second, withholding provides a means of collecting at least a portion of the tax due from winners who fail to file income tax returns. An Internal Revenue Service study of compliance in the reporting of gambling winnings, mandated by the Tax Reform Act of 1976, concluded that there was a strong correlation between rates of compliance and the presence of withholding at the source. Taxpayers subject to withholding had consistently higher rates of compliance than those subject only to information reporting.

Third, from the viewpoint of tax administration, withholding provides a far better mechanism to ensure compliance than does mere information reporting. Withholding on significant gambling winnings automatically collects a portion of the tax liability attributable to those winnings. This helps to reduce the tax agency's audit and collection workloads. Withholding contributes to the efforts by the Internal Revenue Service to discourage the use of so-called "10 percenters," and similar practices to avoid tracing of significant winnings. Withholding raises the cost to the bettor of using a "10 percenter" because the bettor cannot claim a refund for the taxes withheld. Withholding is also superior to mere information reporting because information reporting requires both accurate information documents and a properly filed income tax return to achieve an acceptable "match," as well as the resources to follow up where there are apparent discrepancies. In the absence of withholding, neither the payor nor the payee has any real incentive to verify the accuracy of the statements made on the information return. Inaccuracies, whether intentional or inadvertent, frustrate the ability to match the documents, and raise the overall cost of tracing gambling winnings to the returns. While information reporting is an effective tool to increase compliance, its combination with a system of withholding is a significant benefit from the standpoint of tax administration.

Statement of John E. Chapoton, Assistant Secretary for Tax Policy, Before Subcommittee on Select Revenue Measures, House Committee on Ways and Means, March 16, 1982, pp. 5-6.

In my judgment as a former tax administrator with a deep and continuing interest in preserving our tax system, withholding upon other types of income would have the same therapeutic effects as those which Mr. Chapoton described in his discussion of withholding on gambling winnings. Of course, withholding involves costs, and burdens may outweigh benefits in some instances. Each extension of withholding should be reviewed from this standpoint. However, a claim that withholding is inferior to information reporting in tax administration is untrue.

Sincerely yours,

Donald C. Alexander

Donald C. Alexander

Mr. ALEXANDER. First, I want to commend this subcommittee and the Finance Committee and those who have authored this bill and who have gone on it as cosponsors. It is a great step forward to try to help the tax system, and the tax system is badly in need of help, as you heard earlier.

To have a tax system like ours work you have to have something that is reasonably comprehensible to the public, something the public has reasonable respect for, and a tax system that is equitably and effectively enforced. And we don't have that. Whether we have any of the components I am not sure, but I am sure we don't have the last one because we don't have a tax system that is effectively enforced today.

One of the things we didn't talk about when I was with the IRS for 4 years was the evergrowing tax gap. The reason we didn't talk about it was, we thought talking about it would make it grow further, and our job was to try to make it diminish, not grow. But since you are focusing on the gaps, you need to focus not only on the problem, but on the solution. And the solution is withholding.

Your bill, in one respect on which I labored unsuccessfully in 1976, will strengthen withholding on charged tips. Why? Because you will get better reporting, and thanks to the way the law now works if you get better reporting you will get greater withholding, and you can do something to diminish a very substantial compliance gap.

The Internal Revenue Service fully understands that many tips are shared with those who don't appear to be the initial recipient, and that problem can be satisfactorily resolved by the Commissioner who appeared before you earlier today.

I wish you would extend withholding. I wish you would extend it to areas other than the areas where we now have it—charged tips; wages, of course, where you have remarkably high compliance; and also gambling winnings. The Treasury testified last week about why information returns, however good, are no substitute for the taxpayer and the Government together have a stake in the gambling action. The taxpayer is aware that part of his or her income has been deposited with the Government and that awareness leads to remarkably greater compliance by those who have a duty to file the information returns on which withholding is based and the taxpayers whose information and part of whose stake is given to the Government.

One of the things I want to submit to you is what the Treasury stated on gambling winnings, because it is squarely applicable here even though, unlike wages, they are paid only infrequently to people who are lucky enough to get a big payoff, and maybe that occurs once a year.

But the withholding system works there, and it would work.

One of the problems that I see is the inability of the Congress to face the issue of withholding on independent contractors. I can surely understand the pressures, but the solution is greater withholding.

One last item. I think this bill, as I said, is a great step in the right direction, and I wish you would go further. I have a concern, however, about section 6660, the automatic 10-percent penalty.

In the materials in which the bill was introduced that penalty is mentioned as being applicable to someone who takes a position inconsistent with the published position of the Internal Revenue Service and who doesn't disclose it.

Now, when we study the section itself, we don't find that first requirement. I would suggest, as the Treasury suggested, that you reconsider certain of the details of these provisions, particularly this one, and that you insert a requirement which would add to the present requirement for the application of the automatic penalty; not only that there be a failure to disclose but that that failure be inconsistent with a published position of the Service.

Senator GRASSLEY. Thank you, Mr. Alexander.

Mr. Hickman.

STATEMENT OF FREDERIC W. HICKMAN, ESQ., CHICAGO, ILL.

Mr. HICKMAN. In my statement I have, first, strongly endorsed the approach you have taken by going the information-reporting route rather than the withholding route. I think there is a great temptation to assume that because withholding works well in the case of wages that it will also work well in other areas. There are entirely different factors at work.

My statement tries to lay out why I believe that not to be the case in the case of the administration's proposal for 5-percent withholding on interest and dividends. It seems to me that's not worth going for, for the small number of people who are involved, at the expense of imposing a burdensome system on everybody. And if one goes for more than 5 percent, you are clearly going for a wrong number. There can be no one correct withholding percentage on that kind of income.

Second, the most important thing, I think, in your bill in terms of overall result is the increased funding for the Internal Revenue Service. Audit activity, in a relative sense, has clearly fallen off during the period that I have been practicing law and worrying about these problems. You should regard the Internal Revenue Service as a producer of revenue, not as a spender of revenue. It produces more than any other agency, any other arm of the Government. You have to spend money occasionally to make money. You should look at it that way.

Specifically, with respect to the bill, I have reservations about several details. I think the bill on the whole is an excellent bill.

First, I have reservations about the form of the civil fraud penalty that you have provided. I have no problem about the fact that you have one. But I think, for the reasons explained in the statement, that it will produce unjust results in a good many cases as it now stands.

Second, there are two provisions that deal with the Government not paying interest for specified periods of time. I don't believe they are conceptually accurate. No revenue is involved. There is no problem at all if the interest rate that you set in the statute is a reasonable interest rate, which is a question that you have addressed. I think that should suffice. I would delete those two provisions.

There are provisions with respect to reporting—the Treasury's reporting on regulations. I think, for reasons set forth in the statement, those are counterproductive.

The biggest single reservation that I have relates to the so-called audit lottery or tax shelter disclosure penalty provision. This provision has surface appeal, but I submit to you it is fundamentally wrong.

It rests on the assumption that the great bulk of controversial or unclear, uncertain items in tax returns are items on which taxpayers have taken aggressive positions. That may well be true in the case of individuals. I think it is not true in the case of businesses in general.

While I would have no objection to the application of such a provision with respect to cases where a taxpayer has taken an outrageous position and is subsequently caught, the bill sweeps in a great deal more than that, and I see no way to draft it to confine it to that.

I think what will happen if we get this provision is that we will have books of disclosure information submitted with tax returns. Already major corporate tax returns are apt to be 2, 3, 4, sometimes 6 inches thick. They contain numbers of the most summary sort. The audit procedure gets back into the transactions themselves.

If you turn things on what is and what is not disclosed, I will promise you will have from major taxpayers supplementary disclosure submissions as big as the Code itself, in which you will be hunting again for needles in the haystack.

The threshold provision is no answer. It is tied in this case to the understatement of tax liability. You may have a corporation that has, let's say, $10 million of gross receipts and $9,900,000 of expenses, and it has a $10,000 threshold. Another corporation with the same $10 million may have $8 million of expenses, and it would then have a $200,000 threshold. So, even if you have a threshold, it's the wrong kind of a threshold.

But in general I think that this provision, for reasons that I have tried to explain in my statement, strikes really at the heart of the self-assessment system. I think it would be a terrible mistake. It is not because I don't believe there is a problem, but because I think that this particular kind of approach to it would contribute more to the problem than it would to the solution.

Senator GRASSLEY. Thank you, Mr. Hickman.

Mr. Nolan.

## STATEMENT OF JOHN S. NOLAN, ESQ., CHAIRMAN OF TAX SECTION, AMERICAN BAR ASSOCIATION, WASHINGTON, D.C.

Mr. NOLAN. Thank you, Mr. Chairman.

I strongly support the basic objectives of S. 2198, though some of its provisions require considerably more thought and attention. The views I express here are solely my personal views, not the position of the American Bar Association or its Section of Taxation.

The existing compliance gap in the reporting of taxable income is a national disgrace and does, indeed, threaten the basic integrity of our self-assessment tax system. Noncompliance must be stopped. S. 2198 is a courageous and innovative first step.

The Section of Taxation is giving intensive study to noncompliance problems, particularly in the so-called cash or underground economy, the larger area referred to earlier by Senator Baucus. The results of that study will be made available to this subcommittee as they become available.

Addressing the specific provisions of S. 2198, I support the broader information reporting provisions as to interest in section 101, but I suggest an exception for interest on obligations of small corporations where such obligations are not held by the general public. In endorsing these provisions, however, I do not exclude the possibility that withholding as to interest and dividends may prove to be necessary. While such withholding is not popular politically, it has much justification. The problems that do arise in such withholding and which are unique to it can be resolved by proper attention.

I support information reporting by brokers of securities and commodities transactions of their customers. A compliance rate of only 56 percent with respect to capital gains is indeed a national disgrace; knowledgeable taxpayers are involved.

I question whether information reporting of State and local income tax refunds is justified. The burden on State and local governments will be substantial. Similarly, while the extent of nonreporting of tips income, over 80 percent, is absolutely shocking and deplorable, I doubt that information reporting only as to charged tips will have any significant effect. I would suggest other more drastic enforcement measures such as, for example, denying any business deduction for tips unless charged or unless paid to the restaurant owner for the benefit of the waiter with a receipt obtained.

I am concerned about the provisions authorizing the IRS to require filing of information returns in machine-readable form or on magnetic tape. No standards for exercise of this discretion by the IRS are set forth. Small businesses may not have the capacity to provide such data.

I support sections 111 and 112 providing for semiannual adjustment of the interest rate on underpayments and overpayments based on a 6-months' average of the prime rate, and for semiannual compounding of interest. I also generally support section 113 imposing restrictions on payment of interest on certain overpayments, although I am concerned about not treating the return as filed until it is in so-called processable form. Further explanation of what this means is necessary.

I oppose section 121, imposing a formal penalty on corporate directors, officers, employees, and agents who participate in a corporate fraud which leads to an underpayment of corporate tax. There is very little tax fraud in the case of publicly held corporations. In the case of smaller corporations, the directors and officers are usually also the stockholders who suffer the financial burden of the fraud penalty imposed on the corporation. A double penalty is unwarranted. This provision is vague in some of its application and will seriously inhibit responsible individuals from undertaking important corporate management responsibilities.

In the case of agents—primarily outside lawyers and accountants acting as tax advisors—it duplicates the already-existing tax return preparer penalties. The provision would inhibit corporations from taking reasonable tax positions because the IRS does not agree with them. This is not healthy. The proposed penalty will do little good but could cause great harm to effective corporate management and is not justified by the available data.

I support in part section 122, imposing a $100 minimum penalty for failure to file a return within 60 days of the required date. Such a penalty is certainly justified in the case of taxpayers receiving a refund, though it should not exceed the lesser of the amount of the refund or $100.

The penalty may not be justified in other cases. If no tax is due, or if a very small amount of tax is due, as is often the case for low-income wage earners who rely entirely on the withholding system for payment of their taxes, a $100 penalty may be completely unreasonable.

Mr. Chairman, I support section 124, imposing various penalties and obligations with respect to filing information returns and supplying correct taxpayer identification numbers. I particularly commend the imposition of mandatory withholding where the taxpayer refuses to provide his identification number or supplies an incorrect one. This is a fair and reasonable sanction; it does not penalize honest taxpayers. The idea has great merit, and consideration should be given to expanding its application.

Section 125 of the bill would impose a no-fault penalty on substantial deficiencies arising from items not disclosed in the return. This is designed to change the odds in the audit lottery. I support the general concept of this provision, at least with respect to nonbusiness income, but the provision needs much more thought and development. It is critical that the definition of what is disclosed in the return be fairly drawn and be clear-cut. The standard adopted in the bill is inadequate for reasons discussed in my detailed statement. The application of this penalty to common but highly discretionary adjustments in business tax returns, such as disallowance of deductions for unreasonable compensation, or inventory adjustments, may be inappropriate and requires much more consideration. The threshold levels at which the penalty will begin to apply are probably too low.

I support section 131 providing for broader, voluntary withholding on annuity payments, including distributions from qualified retirement plans, and requiring withholding with respect to lump-sum distributions. For lump-sum distributions, however, I recommend a flat-rate withholding rather than the graduated rate tables for wages.

Finally, I strongly support section 202 in title II making Internal Revenue Service rules, regulations, and tax forms exempt from OMB review under the Paperwork Reduction Act of 1980. The tax administrative process is not the type of regulatory activity to which the Paperwork Reduction Act was directed. Internal Revenue Service rulings, regulations, and tax forms provide essential guidance to taxpayers; the interests of taxpayers are served by greater rather than lesser activity in issuing and improving such rulings, regulations, and forms. The development of these materials requires the particular expertise, experience, and judgment of the Treasury Department. OMB review adds nothing and would result in unnecessary delays and conflicts. Groups such as the taxation section of the American Bar Association and the American Institute of Certified Public Accountants provide intensive and constructive criticism of all such materials. There is no widespread concern among tax experts that the Treasury Department has issued more rules, regulations, or tax forms than the Internal Revenue Code requires.

Thank you, Mr. Chairman.

[The prepared statements of the previous panel follow:]

STATEMENT OF FREDERIC W. HICKMAN BEFORE THE
SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE
SENATE COMMITTEE ON FINANCE
MARCH 22, 1982

My name is Frederic W. Hickman. I am a member of the law firm of Hopkins & Sutter, Chicago. I have been an attorney, specializing in taxation, for more than thirty years. I served as Assistant Secretary of the Treasury for Tax Policy for approximately four years, 1972-1975.

I appear today in response to the Subcommittee's request and not on behalf of any client.

The bill you are considering, "The Taxpayer Compliance Improvement Act of 1982" (S. 2198), is both important and commendable. It will raise significant revenues in the short term. More important, in the long run it will help preserve our self-assessment tax system. That system is the envy of the world, but it shows signs of unravelling.

I agree with most, but not all of what the Bill proposes.

I particularly agree with the emphasis on information reporting rather than withholding.

I particularly disagree with the so-called tax shelter penalty provision. I agree it addresses a serious problem, but I believe it would contribute more to the problem than the solution.

The comments which follow deal first with general considerations and then with selected specifics of the Bill. If the comments seem focused on negative aspects, it is only because those are the aspects in which this good Bill might be made still better.

## COMPLIANCE FUNDAMENTALS

The mainspring of our tax system is the willingness of taxpayers to comply voluntarily with the law. No amount of special rules and increased policing will substitute for that. Anything that can be done to increase the willingness of taxpayers to comply will be far more effective than specific policing legislation.

It is ironic that while our population is enormously more affluent than it was 30 years ago, it appears less willing to pay its taxes. Future historians may well lay this phenomenon to general decadence. But as you seek to stem the tide today, you will need to identify more specific causes. A list of causes would include the following:

- A general decline in the respect for authority.

- A steep increase in the incomes of the working population, part real and part inflationary. The increase in incomes has radically increased the percentage of taxpayers who are taxed at hefty marginal rates. The bulk of the working population used to be in the bottom rate brackets. Today they are in middle brackets -- largely because they are better off (Congress has periodically and, at least partially, adjusted for inflation). Higher rates increase the incentive for non-compliance and the dissatisfaction which gives rise to it. The large number of taxpayers now in these middle brackets suggests that the bulk of the non-compliance dollars is also here.

- Tax growth. Taxes have been pre-empting a steadily growing share of the national income. The increase in rate brackets is a facet of that fact.

- Greater complexity. The tax law has become infinitely more complicated and detailed. Ordinary taxpayers find it hard to understand it and the less they understand, the less likely they are to comply voluntarily. They can hire professionals to deal with the complexity, but that only lessens their sense of personal responsibility.

- Constant change. Revenue acts used to occur, with relatively modest changes, every several years. Since 1968, however, the Congressional tax writing committees have been in almost constant session. Compliance is in large part a habit. It is very hard to make a habit of something that constantly changes.

- Distribution of incentives through the tax system. Increasingly, dollar incentives for various activities have been distributed in the form of tax reductions. There are often major advantages in that kind of distribution system. But one of the disadvantages is that most taxpayers are not equipped to understand the economic substance of what occurs and misinterpret the result as an undue and unfair difference in tax burdens. Most of the "tax shelters" that breed resentment are not the product of legal ingenuity but a straightforward consequence of the incentive distribution system deliberately enacted by Congress. The ACRS system enacted five months ago is the most recent example. The aggregate incentives attached to new business investment are now so large and so designed that each such investment brings into being an independent tax shelter, generating deductions and credits that wipe out the tax on income from the investment itself and from other investments as well. Eventually that will be reflected in statistics suggesting that many businesses bear little or no tax burden and will no doubt contribute to public misperceptions as to the fairness of the system.

Decline in policing. The increase in tax complexity and tax dollars has not been matched by increased tax audit activity because of budget and manpower restraints on the IRS. Moreover, as the Code has burgeoned, so too has the demand for tax professionals. Compensation levels have risen and the IRS has become less competitive in the effort to get and to hold the best people.

The Bill deals in a significant manner with only the last of these fundamentals. It is a good start. But much of the fundamental causes are the result of past Congressional actions. Unless and until Congress is willing to seriously address those fundamental causes we shall continue to have a substantial level of noncompliance, no matter how many additional bills are passed that address fringe aspects.

## INFORMATION REPORTING VS. WITHHOLDING

A basic issue addressed by the Bill is whether it is better to seek increased compliance through withholding on certain kinds of income or through more extensive information reporting.

I strongly endorse the Bill's adoption of the information reporting alternative, coupled with a strengthening of the audit system.

Everyone agrees that there is no excuse for deliberate failure to report income. Most would agree that offenders should be dealt with toughly.

The real issue is the choice between alternatives: how big is the noncompliance problem, how much of it is likely to be solved through withholding, and how burdensome would the withholding system be on everyone? During my tenure as Assistant Secretary, the Treasury considered this issue at length in the context of interest and dividends, as the statistics indicated that very substantial sums were unreported. In the end, we did not opt for withholding proposals.

The shortcomings of withholding on dividends and interest, as I see it, include the following:

1. Withholding on interest, dividends and similar items is much more difficult and less satisfactory than withholding on wages. Most employees work for one employer, on a regular basis throughout the year. The aggregate wage payments are substantial in size and there is a sufficient continuing relationship for the employer to be able to pay and

correctly report the amounts involved. It is almost always clear to whom the income belongs. One can, by gearing the percentage of the withholding to the gross amount of wages, very roughly approximate the tax which will be owing on the wages. None of these things is true with respect to interest and dividends.

2. The original justification for wage withholding was sheer need. Wages account for the great bulk of income in the system. Without withholding, many taxpayers, even those with the best of intentions, would find that they would not have set aside enough of their incomes to pay their tax and the core of the system would collapse. Interest and dividends, on the other hand, are not "core" items in the system and are not even major items for most taxpayers.

3. The "overhead" burden of constructing a withholding system for very large items like wages is much less than for a multiplicity of small items. Withholding on interest and dividends can be done. It could be done even before computers. But we should not deceive ourselves: it would involve substantial expense and effort.

4. A withholding system like that proposed by the Administration will not, in any event, contribute substantially to increased revenue. As the great bulk of interest and dividends is reported by taxpayers, the great bulk of the

effort and expense involved in a new withholding system would relate to taxes which are already being collected. The small minority of taxpayers who are not currently reporting would, through withholding, pay 5% tax. But collection of 5% from a small minority does not represent a significant advance.

During my years at Treasury, some argued that any withholding, no matter how small, would cause a non-reporter to report the total and pay tax. But the argument was unconvincing and the evidence nonexistent. I did not believe it then. In the absence of better arguments and better evidence I do not believe it today.

It seems to me much more likely that withholding at a nominal 5% level would, if anything, ease the conscience of the non-reporter and lessen the pressure for the IRS to give vigorous chase to the non-reporter. My own view is that we will get better results by improving the system of information reporting, pursuing that information vigorously and "throwing the book" at offenders when they are caught.

I am mindful that withholding at a nominal 5% level may, in reality, be intended simply as a "foot in the door," and that, once enacted, the 5% can be escalated to some higher percentage. But even if one thought that to be a desirable tactic, setting an appropriate percentage is virtually impossible for items of this kind. Even in the case of wage withholding, the withholding percentages are very imprecise; but the system can be tailored within reasonable ranges because wages constitute the bulk of most taxpayers' income and the amount of wages subject to withholding will have some rough relationship to the rate at which tax will ultimately be paid. That is not true of interest and dividends. A bank paying $1,000 of interest has no idea whatever of the recipient's other income and of whether the $1,000 will be taxed at zero, at 50% or at something in between.

5. Withholding on interest and dividends has a side effect which is particularly undesirable, particularly under present economic conditions. If withholding held promise of being truly effective one could dismiss the side effect as simply the price to be paid for an effective system. But if the system is likely to be ineffective in any event, the side effect needs to be weighed in the balance. The side effect is that imposing a withholding tax on these items is likely to have an adverse effect on saving and thus on investment and interest rates. That is because withholding, in effect, pays tax directly from that pocket which the taxpayer normally regards as his savings pocket. The amount withheld on his savings account, for example, reduces the balance in that account. The taxpayer may, of course, replace it from his current income, but many taxpayers will not.

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6. There is some virtue in requiring taxpayers to pay tax directly rather than having it conveniently withheld. Paying directly is a constant reminder that the Government is exacting the tax and thus a constant invitation for the taxpayer to consider whether the expenditures which require that tax are necessary. The Government sector would arguably be much smaller today if we had not had withholding on wages. Be that as it may, the income tax probably could not carry the load it does today without wage withholding. But withholding on interest and dividends is not indispensable and the nation is probably better off if there is a significant layer of tax liabilities which is not rendered invisible and less painful by withholding.

7. In sum, noncompliance with respect to interest and dividends is a significant, but far from overwhelming problem. The great bulk of dividends and interest is reported. For the balance, improved information and vigorous enforcement with respect to the errant minority should accomplish more at less cost and will avoid imposing a burdensome new system on the majority.

## IRS BUDGET INCREASES

The most important item in the package of proposals is the proposed increase in IRS funding. It is long overdue and should be given top priority.

The IRS should be viewed not as a spender, but as a producer. It is the only significant revenue producer the Government has. Money wisely spent there will, today, return revenue many times greater than what is spent.

There is a point at which additional IRS funding will no longer pay for itself several times over. But we are a long way from that point.

At the same time, too much money, all at once, is not good either. No organization can wisely spend too much too fast.

Your Committee will find the correct balance only by careful weighing of the facts. When in doubt, you should err in the direction of too much rather than too little.

## INFORMATION RETURNS

### Reporting with Respect to Bearer Instruments, Brokerage Transactions, State and Local Income Tax Refunds, and Charge Tips

Each of the Bill's provisions for expanded information reporting is desirable, providing it really contributes important information in the enforcement effort and providing, further, it does so at a cost which is not wholly out of line with the value of the information produced. It is far from clear, however, that will be the case.

The danger is that the system, once authorized, will be over-designed. In the case of brokerage accounts, in particular, the fragmentary nature of the information possessed by the broker raises serious questions as to whether anything that will be useful to the IRS can be designed at a cost that is not exorbitant. The Committee will need to listen carefully to the comments and criticisms of the institutions affected and perhaps limit more explicitly the information that can be required.

On a related note, information reporting should be adequate (and withholding unnecessary) with respect to employee plan distributions.

Form of Information Returns

The Bill gives the IRS specific authority to require that returns be made in a form, including magnetic media in the case of a person required to file multiple returns, determined by the IRS to be necessary for processing on IRS equipment. This proposal seems reasonable, assuming that the cost of compliance, especially in the case of small business, is not excessive.

## INTEREST

### Semi-Annual Compounding of Deficiency or Refund Interest

The proposal to require compounding of deficiency and refund interest would bring the interest provisions of the

Internal Revenue Code more into line with commercial practices. Large dollar amounts can be involved here, and the change is important and desirable.

Your Committee should be aware, however, that interest computations are not as simple as almost everyone casually assumes. They often involve substantial controversy between the Government and the taxpayer and substantial uncertainties that delay administrative processing. Insofar as the Bill provides for a combination of compounding and more frequently changing statutory rates, the computation problems will increase.

Semi-Annual Determination
<u>of Interest Rate</u>

For many years interest was provided for at a flat statutory rate of 6%. Proposals for a changing statutory rate were under extended discussion during my tenure at the Treasury and were ultimately adopted.

Modest differences between statutory rates and marketplace rates do not greatly affect taxpayer behavior. In a period of relatively stable interest rates, frequent adjustments of the statutory interest rates create more administrative complexity than the dollars involved warrant. However, in recent years, we obviously have not been blessed with stable interest rates. Reluctantly, I conclude that the substantial dollar amounts at stake in the current period of volatile interest rates justify the substantial administrative problems created by frequent rate adjustments. In the current economic environment semi-annual determinations are probably appropriate.

<u>Restrictions on Payment of Interest on Certain Refunds, Etc.</u>

The Bill contains two provisions which would stop the running of interest in situations in which the taxpayer has not taken certain actions. The underlying concern of the draftsman seems to be that taxpayers will deliberately leave money with the IRS if they believe the statutory rate to be high in comparison with the market rates.

Thirty years of practical experience with taxpayers tell me that this is not a realistic concern. Taxpayers seldom, if ever, act that way and even if they did, the Bill's provision for more frequent changes in the rate should solve the problem.

Current law has the virtue of establishing a definitely determinable date for the commencement of interest and reflects the economic reality that the Government has the use of the taxpayer's money during the period dealt with in the Bill (and longer).

These two provisions should be deleted. No significant revenue impact is involved, either way. If the Committee believes that the statutory interest rate is so high that it gives taxpayers that receive interest an undue advantage, then it is also so high that it imposes a penalty on taxpayers that pay interest. The solution lies not in these provisions, but in better provisions for statutory interest. The Bill so provides and that should suffice.

## DELAYED REGULATIONS

S. 2198 would provide explicitly that Treasury issue rules and regulations implementing Code amendments as soon as possible and report annually to Congress with respect to any delays in issuing such regulations, the reasons for such delays, and any progress made in eliminating such delays.

This is not a useful provision and should be deleted. It simply imposes another layer of bureaucracy. Treasury and the IRS are very sensitive to which regulations are needed promptly for taxpayer guidance and which have only marginal importance in that regard. Every effort is made to provide the needed guidance in timely fashion. The record, I submit, is excellent. Taxpayers complain routinely, sometimes justifiably. But they complain even more vigorously when hurried regulations come out "wrong."

Issuing regulations does not, of course, eliminate all uncertainties. Many regulations create more new uncertainties tnan they solve old ones. Other regulations are revised and re-revised over many years. Mechanical rules requiring promulgation are likely to result primarily in pro forma regulations that do not resolve the hard problems and in a new layer of reports that is useful neither to Treasury nor Congress. That would delay the real work even longer.

Delays in providing the necessary regulations guidance are not attributable to a lack of diligence on the part of Treasury or IRS personnel. They are attributable principally to the sheer volume of tax legislation proposed and enacted each year. Until there is some abatement in legislative activity, there is little reason to expect a significant reduction in the regulations and rulings backlog, regardless of what status reports are required.

## PENALTY PROVISIONS

### Failure to File Information Returns or Supply Identifying Numbers

The Bill relies extensively on a system of matching information reports with a taxpayer's tax return computations. That system can be effective only if there is a meaningful penalty for failure to file the required information returns.

The current penalty of $10 for each failure, with an aggregate maximum penalty of $25,000, is too low to be an effective deterrent. The proposed increase to $50 per failure, with an aggregate maximum of $50,000, is warranted, and perhaps still too low to operate as a deterrent in many cases. Application of the increased penalties to failures to supply identifying numbers is also a reasonable step.

Fraud Penalty on Corporate
Directors, Officers,
Employees and Agents

Under the Bill, a new civil fraud penalty would be imposed on corporate directors, officers, employees or agents who knowingly participate in fraud that results in an underpayment of tax by the corporation. I support in principle the proposition that corporate officials should be subject to both criminal and civil fraud penalties.

However, this particular civil fraud penalty is wrong. It is inflexible, unrelated to any private gain the individual may have had, and would, in many cases, be harsher than the criminal penalties that would likely be imposed by a judge.

In my experience, the most troublesome cases are those in which relatively low level employees have participated, without private gain and for reasons that are often inexplicable, in actions that are essentially fraudulent. The expense, disgrace and mental suffering they incur as the facts unfold and they face possible prosecution are usually heavy punishments, and thoughtful judges often conclude that justice is done with sentences that are not heavy. In short, they try to tailor the punishment to fit the crime.

The civil fraud penalty which now exists is designed for the person or entity that has profited by the fraud and it exacts a penalty which is measured by reference to that profit. Except in the case of very high bracket individuals, the penalty will not exceed the profit realized from the transaction. A $100,000 penalty on someone who has profited $200,000 seems fair. A $100,000 penalty, imposed automatically on someone who may not have profited at all may be very unfair and perhaps more devastating than a criminal conviction.

This provision needs further thought.

Penalty for Substantial Understatement

S. 2198 would impose a penalty of 10% of the amount of an underpayment of tax if the underpayment exceeded the greater of $5,000 ($10,000, in the case of a regular business corporation) or 10% of the amount of tax required to be shown on the return. However, for this purpose, the amount of the underpayment taken into account cannot exceed the underpayment that would have resulted if "disclosed items" had been properly included in the return. Since the underpayment penalty can be avoided in the case of a "disclosed item" the definition of that term is obviously critical. Under the Bill, a "disclosed item" would be defined to mean:

> Any item which is described in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

This provision has a certain surface appeal, but it is fundamentally wrong.

In the isolated case of the taxpayer who takes an outrageous position, the provision would be reasonable. But that is not the normal case to which the provision would apply and I know of no way to confine the provision to the isolated case. In the normal case, the provision would introduce enormous new complexities, would discriminate unfairly among taxpayers in the imposition of penalties, and would generally subvert the self-assessment system.

Under any income tax, and especially under an income tax as complicated as we have made ours, uncertainties are unavoidable. Even when the Internal Revenue Service has taken a regulation or ruling position with respect to an item, it may be unclear whether or not that ruling or regulation is correct and, even if correct, it may be unclear whether and to what extent it applies in the taxpayer's case. The tax return in any active business contains numbers of only the most summary sort and every IRS audit involves going behind those summary numbers into the transaction records. By their nature, tax returns are not designed to identify specific individual transactions.

If a provision of this kind were enacted the supplementary "disclosure" material which large businesses would be compelled to prepare and file each year in order to avoid penalties could be as large as the Code itself. A whole new profession of writing "return disclosure briefs" would emerge. A whole new generation of lawyers and accountants would have ~~a new~~ vocation. The gamesmanship aspect of return preparation would be greatly expanded and the entire self-assessment system would be weakened.

The "threshold" requirement would lessen the impact only slightly and because some companies would have much larger thresholds than other companies of the same size and nature, would cause the penalties to be imposed in an arbitrary and discriminatory manner. Most companies would feel obliged to go through the entire disclosure exercise regardless of what they thought their threshold would be, as no one can accurately tell what timing adjustments and carrybacks and carryovers with respect to other years might do to the estimated threshold.

And companies that happen to have small tax liabilities would have little or no threshold at all.

The success of a voluntary tax system depends upon charging taxpayers with responsibilities which they find generally reasonable. If the requirements are widely regarded as unreasonable or cut against the grain of human nature, the system will fail and no amount of penalty or coercion will make up for the loss of voluntary compliance. A system which requires the taxpayer to identify all potential questions will not be viewed as reasonable. It will be regarded--accurately --as a system that invites an IRS auditor to resolve those questions against the taxpayer. It will not work.

Our existing system trusts taxpayers to make honest judgments and on the whole they do. As Justice Frankfurter put it, "If you wish people to be trustworthy, you must trust them." To require the routine disclosure of all items which might be conceivably resolved against the taxpayer not only would impose an extraordinary layer of new compliance complexity, but, more fundamentally, would tamper with the wellspring of the system. It would be a radical change in the day-to-day operation of the system and a repudiation of its philosophical underpinnings. It would be a terrible mistake.

STATEMENT OF JOHN S. NOLAN
SUBCOMMITTEE ON OVERSIGHT, SENATE FINANCE COMMITTEE
S. 2198, "THE TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1982"
MARCH 22, 1982

COMPLIANCE GAP -- UNDERGROUND ECONOMY

Mr. Chairman and Members of the Subcommittee --

I appreciate your invitation to testify before this Subcommittee as a former official of the Treasury Department. Over the last thirty-five years, I have devoted considerable study to the integrity of our self-assessment tax system and to improved tax administration. I strongly support the basic objectives of S. 2198, although some of its provisions require considerably more thought and attention. That is my understanding of the spirit in which these hearings are being held today -- the proposals in S. 2198 are presented for informed study and debate as a starting point. My views as set forth in this statement are solely my personal views; they do not represent the position of any organization of which I am a member.

The existing compliance gap in the reporting of taxable income is a national disgrace. Estimates of its magnitude necessarily are difficult, but whether one refers to Internal Revenue Service estimates or to those made by Congressional Committees or the General Accounting Office, the extent of taxpayer noncompliance is dangerously serious and growing. In 1979, the Service estimated that, for 1976, underreporting of income in the "legal sector" ranged from a low of $74.9 billion to a high of $99.7 billion. More recent estimates of the compliance gap are higher.

The causes for the gap are not readily apparent. Clearly, high rates of inflation in recent years and the concomitant "bracket creep" have contributed to the problem. Complexity in the tax laws has been a major factor, as have the active promotion of tax shelters (legitimate and abusive), overstatements and misunderstandings in the public media as to the operation of tax incentives too-often labelled as tax loopholes, and the general uneasiness which many citizens feel as to the growth and direction of government spending. Whatever the cause, however, this hemorraging of the Federal treasury must be stopped. Strong medicine is required, and is justified by the circumstances.

Recognition of the compliance gap and a willingness to do something about it are important first steps. At a time when triple digit budget deficits face us, it is particularly important that the Government collect all those taxes which are legitimately owed. Just as importantly, issues of fairness -- and the perception of fairness -- are at stake. Ours is a self-assessment tax system. Its viability as a revenue gathering system is dependent upon voluntary compliance of taxpayers. If some citizens fail to report and pay their fair share, other citizens are injured, and their perception as to fairness of the system, and their willingness to comply with its requirements, will diminish. The consequence is an erosion of the tax system itself.

The Section of Taxation of the American Bar Association is engaged in intensive study of the "compliance gap" and "underground economy" problems. While time has not permitted the Section to take a position as yet on the provisions of S. 2198, the Section is presently undertaking a thorough technical analysis of the bill. Comments will be submitted at the earliest possible time. The Tax Section has formed a Task Force under the chairmanship of Gerald A. Feffer, former Deputy Assistant Attorney General, Tax Division, United States Department of Justice, to focus upon the existing, widespread failure to report income in the so-called cash economy. William A. Smith, former Deputy Commissioner of Internal Revenue, Edward N. Delaney, former Vice-Chairman of the Section, James E. Merritt, Chairman, Committee on Administrative Practice of the Section, and many other outstanding tax lawyers in the Section are contributing to this work. The Section will present the results of this study to the Subcommittee upon its completion.

S. 2198 introduced by Senators Dole and Grassley on March 11, 1982, attempts to address many of the major noncompliance problems which have developed under present law. S. 2198 would expand the information reporting requirements of present law, impose new civil penalties for noncompliance, and revise withholding provisions with respect to pension and annuity distributions. S. 2198 would also substantially revise the computation of interest on refunds and underpayments.

While as I have said, I agree with objectives of S. 2198, in certain cases the provisions of S. 2198 go too far and may produce unintended results. Therefore, I urge the Subcommittee to carefully examine the statutory language and its effect upon taxpayers.

Title I

Sec. 101 -- Information Reporting: Bearer Obligations, Transactions by Commodities and Securities Brokers for Customers

Sec. 101(a): Bearer Obligations. This provision would expand present law to require information reporting with respect to interest on all corporate obligations, including bearer obligations and obligations of the United States or its agencies or instrumentalities. It would apply also to original issue discount on these types of obligations.

Present law does not require information reporting as to obligations of the United States. While present law authorizes the Treasury Department to provide for information reporting with respect to indebtedness "of a type offered by corporations to the public" (Code §6049(b)(1)(A)), which would extend to bearer obligations of private corporations, the Treasury Department has never provided for information reporting with respect to interest on such obligations.

It is my understanding that in the past, the Bureau of Public Debt of the Treasury Department has opposed expansion of the information reporting rules to include obligations of the United

States. As a policy matter, the Treasury Department's failure to implement information reporting on the same basis as is required of private obligors is unacceptable.

The other change in present law made by §101(a) of the bill would, as previously stated, extend the information reporting requirements to interest on bearer obligations of corporations. The bill would repeal the existing authority of the Treasury Department to prescribe regulations establishing the type of corporate obligation as to which reporting is required. The purpose of this provision is to require information reporting on all corporate obligations.

While universal information reporting might at first blush seem to be a desirable objective, it may impose undue burdens on smaller corporations. It may be extremely difficult, for example, to determine if there is original issue discount on obligations of a small corporation not traded on the market. It is unlikely that information reporting of interest on obligations of small corporations will have any significant effect on the compliance gap; the obligations of such corporations are usually either held by banks or the shareholders, and they know full well the amount of interest they have received and their obligation to report it as income. In addition, the absence of information reporting on obligations of unincorporated business entities creates an impression of inconsistent treatment based solely on the form under which a business in conducted.

Thus, the implications of this change in the reporting of interest of small corporations should be carefully considered by the Subcommittee. The Subcommittee may wisn at the very least to authorize the Treasury Department to prescribe regulations which would exclude certain types of corporate obligations from the reporting requirements where a significant noncompliance problem does not exist, explaining in its Committee report that this is designed to permit appropriate exceptions for small corporations.

The provisions of §101(a) of the bill are otherwise entirely appropriate and should be enacted. The noncompliance gap cannot be resolved until, at the very least, all major issuers of interest-bearing obligations held by the public file information returns. In endorsing these provisions, however, I do not exclude the possibility that present conditions may require the enactment of withholding on interest and dividends. While such provisions are not popular politically, they may become necessary to preserve the integrity of the self-assessment system. The Subcommittee's data show that compliance is highest with respect to wages -- in excess of 99%. This is clearly because of withholding. Withholding has many advantages, and most of the problems which are foreseen in withholding as to dividends and interest can be avoided by careful analysis and implementation. The Subcommittee should, at the very least, monitor the effectiveness of information reporting carefully over the next several years, and if it is not effective, consider the need for broad-scale withholding on non-wage income.

<u>Sec. 101(b): Securities and Commodities Transactions.</u> This provision would simply direct the Treasury Department to prescribe regulations under existing Code §6045. Section 6045 requires brokers to make returns as required by regulations with respect to business transacted for customers. Such returns would include the customers names and other information relating to the profits and losses arising from such transactions.

No regulations have been prescribed under §6045 even though the provision has been part of the tax laws for forty years. It is my understanding that the Treasury Department is reluctant to prescribe regulations at this late date because of its concern that brokers will strongly oppose the imposition of any type of reporting requirements.

It is the fact, however, that nonreporting of profits is particularly significant in these types of transactions. The Subcommittee's data indicate that only 56% of capital gains are reported. Since capital gains for the most part are realized by knowledgeable taxpayers, this statistic is particularly reflective of the national disgrace which is evidenced by the noncompliance gap.

In any event, it seems entirely appropriate that information reporting by brokers with respect to securities and commodities transactions which they handle for customers should be required. Accordingly section 101(b) of the bill should be enacted.

Sec. 102 -- Information Reporting:
State and Local Income Tax Refunds

This provision would require information reporting as to state and local income tax refunds, credits, and offsets. In addition, state and local governments would be required to file statements with respect to such returns with the recipients of such refunds, credits, and offsets.

It is my understanding that the compliance problem in this area is not as significant as in the other areas. This apparently results from the fact that the current Form 1040 includes a line item for refunds. While information reporting would increase compliance, these benefits must be weighed against the resultant administrative burden placed on the state and local governments. S. 2198 attempts to address this problem, in part, through voluntary information exchange agreements between the Internal Revenue Service and the states. Nonetheless, the administrative burden of providing the recipients of such refunds with statements would appear to make the need for this provision very questionable absent greater taxpayer noncompliance than that which currently exists.

Sec. 103. Information
Reporting: Charged Tips

This provision would require certain employers who pay over to an employee an amount of tips charged against credit cards in excess of $600 in any year to report those tips to the Internal Revenue Service. Small employers, defined as those having employed five or fewer employees during the previous calendar year, are exempted from this reporting requirement.

This provision, in effect, repeals an amendment in the reporting requirements enacted in 1978. Prior to 1978, all employers were required to report charged tips totalling more than $600 per year. In 1978, as a result of concern as to the administrative burden imposed on employers by the reporting requirements, Congress exempted all employers from reporting charged tips. This provision would return to the pre-1978 law by reimposing the requirements on all employers other than small employers.

The arguments raised in 1978 reflect the considerations the Subcommittee should weigh in again applying reporting requirements -- that is, the need to insure compliance versus the administrative burden imposed on payors. The effectiveness of this provision is questionable; American Express, for example, may simply delete the line on its charge slips for tips under pressure from its restaurant customers. More sophisticated and extensive enforcement of the existing withholding requirements, which require written statements of tips by employees to their employer (Code §6053(a)), is surely required in any event.

Sec. 104 -- Form of
Information Returns

This provision would authorize the Treasury Department to prescribe regulations requiring any person required to file information returns to file such returns in machine-readable form or on magnetic tape. In contrast, present law allows taxpayers to provide information on magnetic tapes or other mediums, provided the prior consent of the Internal Revenue Service is obtained.

A primary concern with this provision is the absence of any standards or criteria which must be utilized by the Internal Revenue Service in requiring machine readable or magnetic tape returns. In effect, this provision gives the Internal Revenue Service a blank check in prescribing the form of returns it may require.

The Subcommittee should consider whether the Internal Revenue Service should be authorized to require a person to provide magnetic tapes where such tapes are not regularly used in the taxpayer's business activities. This is merely one example of the type of problem which could arise under this provision. At the very least, the accompanying committee report should include a discussion of the intended scope of the authority of the Internal Revenue Service under the provision.

Sec. 111 and 112 -- Interest
Rate and Compound Interest

Section 112 would result in the rate of interest on overpayments and underpayments being determined semiannually based on a six months' average of prior prime rates (rather than annually based on a one month's prior average as under present law). Section 111 would require semiannual compounding.

The wide fluctuations in the prime rate and the resulting present 20 percent statutory interest rate under Code §6621 demonstrate the need for using a more representative average adjusted prime rate rather than the prime rate for a limited prior period. In addition, the absence of compounding has very substantially lowered the effective cost of borrowing funds from the Federal Government and thus has created incentives to delay the resolution of tax deficiencies.

The changes proposed with respect to interest effectively address these problems and should be adopted.

Sec. 113 -- Restrictions
on Interest on Overpayments

This provision would make two changes in present law. No interest would be paid on overpayments on late returns for the period beginning on the due date of the return and ending forty-five days after the return was in fact filed. A return would not be treated as filed until it is filed in "processable" form. In addition, no interest would be paid on overpayments arising from certain types of carrybacks for the period prior to the date a refund claim is filed.

Both changes are intended to deal with defects in present law as to interest on overpayments. The first change addresses the situation where the Internal Revenue Service does not make a refund within forty-five days after a late return is filed. Under present law, interest would be due in such case for the entire period from the due date of the return until the date of the refund, thereby including the period during which the return was late.

The second change addresses the situation in which a carryback arises in one taxable year, but a claim for refund is not filed until a later taxable year. Under present law, interest would accrue from the close of the year in which the carryback item arose, even though no refund claim was filed in that year.

Both of these changes are appropriate. A question arises, however, as to the denial of interest in the case of a return which is not a "processable" form. The statutory language is vague and imprecise as to the definition of a return which may be processed. Some standards should be set forth in the bill or the Committee report to provide guidance as to when a return is deemed to be processable.

Sec. 121 -- Fraud Penalty on Corporate
Directors, Officers, Employees, Agents

This provision would impose a penalty upon directors, officers, employees, or agents of a corporation who knowingly participate in tax fraud on behalf of the corporation resulting in an underpayment of tax by the corporation. The penalty is an amount equal to 50% of the part of the underpayment of corporate tax attributable to the conduct of such individuals, with a maximum penalty of $100,000 per individual per return. Any such individuals are jointly and severally liable for any penalty imposed.

This provision was drawn from a recommendation of the Tax Section of the New York State Bar Association based on the fact that the present civil fraud penalty does not have a direct financial effect on individuals responsible for a corporate underpayment of tax due to fraud. Thus, directors, officers, employees, and agents of large public corporations are not otherwise subject to personal liability by reason of the tax fraud of the corporation.

While this objective has merit, the penalty as drafted may not operate properly to solve this problem and could create other serious difficulties.

The number of instances in which large public corporations engage in tax fraud are relatively few. The threats of stockholder derivative suits, and other sanctions, provide deterrents to fraudulent conduct on the part of directors, officers, employees, and agents of large public corporations. The Subcommittee's own data show that only 5% of the noncompliance gap is attributable to the corporate sector, and it is likely that only a small part of this 5% is attributable to public corporations. It is not at all clear that this new penalty would serve any substantial purpose in the case of large public corporations.

The principal application of the penalty would, therefore, be with respect to officers and directors of small, closely-held corporations. In most small, closely-held corporations, however, the directors and officers of the corporation are also substantial stockholders. Thus, when such small corporations commit tax fraud, the impact of the current 50% penalty falls upon the individual officer-director stockholders who perpetrated the fraud. The application of this proposed new fraud penalty on top of the current 50% penalty may result in the imposition of a double fraud penalty upon the officer-director stockholders of small corporations.

The proposed penalty could become a very serious and unwise inhibition upon individuals being willing to serve as directors of, or in other positions of responsibility for, large or small corporations. Since such individuals would be subject to potential personal liability, they may be unwilling to serve at all. Thus, proposed Code §6653(f)(3)(A) states that "knowing participation in fraud" includes participation with respect to which such individual "knew, or should have known, that such participation would result in an underpayment of tax". This is an extremely broad and imprecise standard, and it could result in fraud penalties on individuals who acted entirely in good faith but were somewhat negligent, careless, or simply inattentive in their work. This is a very severe penalty which could operate entirely out-of-line with the degree of seriousness of fault of the individual on whom it is imposed. The risks that it creates will surely deter many persons from providing valuable service to the economy in the management of corporate business.

Furthermore, the proposed penalty may decrease the fairness of the tax system by inhibiting responsible corporate officers, employees, and tax advisors from taking positions regarding corporate tax liabilities which, though arguably correct, may be attacked by the Internal Revenue Service. It is to be noted that the bill, in referring to "agents", would include attorneys, accountants, and other independent persons providing tax advice to the corporation. The fairness and equity of the tax system is not served by inhibiting taxpayers from taking positions on tax issues which have a reasonable basis, irrespective of the Internal Revenue Service position on the matter. Compare Reg. §1.6694-1(a)(4).

Insofar as the penalty would extend to attorneys, accountants, or other tax advisors, it would seem to serve the same objectives as the "tax return preparer" penalties in Code §6694. These penalties apply, of course, to a person rendering advice directly relating to the return whether or not the person prepares or executes the return. General Explanation, Tax Reform Act of 1976, pp. 347-349. In view of the serious dangers presented by this proposed new fraud penalty on individuals, it is doubtful that its application to such "agents" is justified.

In my view, section 121 should not be enacted.

Sec. 122 -- Minimum Penalty
for Extended Failure to File

This provision would impose a minimum penalty of $100 for failure to file a return within sixty days of the required filing date.

It is my understanding that this provision was designed to address the problem of taxpayers who fail to file returns but are entitled to tax refunds. The $100 penalty is intended to offset costs incurred by the IRS in locating such taxpayers for the purpose of refunding their taxes. As drafted, however, the proposed penalty is much broader in scope. The proposed $100 penalty would apply to all individuals who fail to file tax returns within sixty days of the date prescribed for filing, whether or not any tax is in fact due. A $100 penalty may be far too great where there is a relatively small, or no, tax liability.

Thus, there are many individuals of limited education who rely entirely on the wage withholding system and who do not file returns. It is unrealistic to think that they can ever be expected to file returns. If the result of withholding is that they have very little or no tax due, it is unreasonable to impose a $100 penalty upon them. Similarly, if the taxpayer is entitled to a $25 refund, there should be no such penalty in excess of the $25. The penalty should be imposed only on taxpayers whose returns result in a refund and only in an amount not exceeding the lesser of $100 or the amount of the refund. The penalty should be explained as a reimbursement to the Government for the added cost of processing a refund without a return from the taxpayer.

Sec. 123 -- Relief from Criminal Penalty Where
Exception to Estimated Tax Requirement Applies

This provision would relieve a taxpayer of any criminal penalty for failure to pay estimated tax if the taxpayer is relieved of the estimated tax "addition" under Code §6654 because one of the four exceptions in §6654(d) applies. This provision is entirely sound and should be enacted; it corrects an anomaly in existing law which should not exist. The references to §6654 and §6654(d) should be expanded to include also §6655 and §6655(d) in the case of corporations.

Sec. 124 -- Failure to File Information Returns or Supply Identifying Numbers

This provision would increase from $10 to $50 the penalty for each failure to file information returns. It would also increase the maximum annual penalty for multiple failures to file information returns from $25,000 to $50,000.

The provision would also make substantial revision in the rules for failure to supply taxpayer identification numbers. Thus, a taxpayer who fails to include his identification number in his return, or who fails to furnish his number to another person, will be subject to a $50 penalty. Under the bill, the failure to furnish an identification number, or the furnishing of an incorrect identification number, to a person who is required to file information returns with respect to payments to the taxpayer would result in withholding of tax on such payments. The rate of withholding is established at fifteen percent. This provision would, in general, apply to information returns filed with respect to wages and other compensation and interest and dividends.

The provision would increase the penalty from $5 to $50 for failure to include in a return made with respect to another person such person's identification number. In addition, a $100 penalty would be imposed where the failure to include such person's identification number was intentional.

The most significant aspect of these revisions is the provision dealing with withholding. Under that provision, as stated earlier, the failure to furnish an identification number or the furnishing of an incorrect identification number will result in withholding until the correct identification number is furnished to the payor. This unique provision reflects commendable ingenuity. It is a very fair but effective means of increasing compliance, and the application of this concept to other areas deserves further consideration. Because of the potential benefits of this provision, coupled with the fact that it does not "penalize" or burden honest taxpayers and payors, the provision should be enacted. The other elements of section 124 of the bill should also be enacted.

Sec. 125 -- Penalty for Sub-
<u>stantial Understatement of Tax</u>

This provision would add a new penalty to the Code. The penalty would be ten percent of the amount of any underpayment of tax arising, in effect, from an item not disclosed in the return. The penalty would apply to individuals only where the underpayment exceeds the greater of $5,000 or ten percent of the amount of tax required to be shown on the return. In the case of a corporation, the threshold amount would be the greater of $10,000 or ten percent of the tax required to be shown on the return.

This penalty is the most far-reaching and controversial provision in S. 2198. The penalty is imposed without regard to fault or the cause of the underpayment if the item to which the overpayment is attributable is not disclosed in the return. This puts tremendous importance on the test that determines whether the item has been disclosed in the return.

The definition of a disclosed item is taken from the provisions of §6601(e) of the Code. Under that provision, the statute of limitations for assessment of a tax deficiency is extended from three to six years for returns with respect to which there is a substantial omission of gross income. In determining whether a substantial omission exists, disclosed amounts are not taken into account.

A large body of case law has developed under Code §6501(e) as to whether an amount or item has been disclosed. This development has not provided a satisfactory standard for implementation of this no-fault penalty provision. Thus, disclosure in an amended return filed six months' later was held insufficient under §6501(e) to avoid the longer statute of limitations. Foster v. Commissioner, 45 BTA 126 (1941), aff'd 131 F.2d 405 (5th Cir. 1942); see also John H. Houston, 38 T.C. 486 (1962). Income erroneously reported on the return of an estate by an executrix who should have reported it personally was held not to have been adequately disclosed. Anna Eliza Masterson, 1 T.C. 315 (1942); see also Leslie H. Green, 7 T.C. 263 (1946); Corrigan v. Commissioner, 155 F.2d 164 (6th Cir. 1946). It is doubtful that a penalty should be arbitrarily applied in these types of cases.

A better approach would be for the Subcommittee to establish specific standards with respect to the definition of disclosed items for purposes of this penalty provision. The meaning of "nature and amount of such item" (proposed Code §6660(c)(1)(A)) should be further explained. The standards should provide considerably more guidance as to what will constitute adequate disclosure. Disclosure should not be limited to disclosure "in the return", or "in a statement attached to the return", if it is otherwise adequate, has all necessary identification, and is in a form that it can be readily associated with the return.

The application of this penalty with respect to activities of a trade or business deserves more study. Underpayments attributable to highly-discretionary adjustments by the Internal Revenue Service, the facts with respect to which are reasonably apparent on the face of the return, but as to which there is no specific disclosure in the return, present special considerations. This would include such items as unreasonable compensation, additions to bad debt reserves, amounts capitalized which were treated in the return as repairs, useful lives for depreciation purposes, the extent to which indirect costs are allocated in valuing inventories at cost, write-downs of inventory to market where lower than cost, and others. The Service normally looks at these items in any business return, and it is questionable whether a penalty should be imposed simply because there is no specific disclosure. These types of adjustments produce large deficiencies, but if the interest rate is adequate and the taxpayer's position had a reasonable basis, there should be no penalty.

There will be endless disputes whether such an adjustment arises from an item "described in the return" (proposed Code §6660(c)(1)). Business returns may become weighted-down with unnecessary "disclosures". The cost of filing returns, particularly for small businesses, may become prohibitive as lawyers and accountants prepare extensive and carefully-worded "disclosures".

It is possible in any event that the threshold amounts have been set too low. The $5,000 amount for individuals perhaps should be $10,000; compare, for example, Code §163(d). The $10,000 amount for corporations (other than Subchapter S corporations and personal holding companies) perhaps should be $25,000.

Nothwithstanding the foregoing criticisms, the proposed no-fault penalty is sound in principle and should be enacted in some form. It should be noted, however, that this penalty does not adequately address noncompliance problems arising from tax-sheltered investments. In most instances, tax shelters are fully disclosed in either the taxpayer's return or in a partnership return referred to in the taxpayer's return. As a consequence, the penalty would not be applicable to an underpayment arising from such an investment. It may be necessary to consider some other sanction for such cases.

It is relevant in this respect that the Standing Committee on Ethics and Professional Responsibility of the American Bar Association has recently promulgated a revised statement of Ethics Opinion 346 providing rigorous ethical standards for tax-shelter opinions. This may have a salutary effect on the compliance problem with respect to such investments.

Sec. 131 -- Withholding
on Deferred Income

Under present law, no withholding occurs as to amounts paid under various types of annuities unless the recipient elects withholding. In addition, no withholding is required as to lump-sum distributions from a qualified retirement plan on an IRA. This provision would change present law to require the recipients of annuity payments (which include distributions from a qualified retirement plan) to elect-out to avoid withholding. In addition, it would require withholding on lump-sum distributions in all cases except where the recipient notifies the payor that the distribution will be rolled over to another qualified plan or to an IRA. The provision would treat lump sum payments and annuity payments as wages; as a consequence, withholding would occur on a graduated basis.

The annuity case presents a particular noncompliance difficulty because of the provisions of present law which permit employees in certain circumstances to recover their non-deductible contributions out of the initial annuity payments from a qualified plan. This can result in the annuity payments being tax-free for up to three years and will affect the taxpayer's ability to pay the tax (in the absence of withholding) where the amounts suddenly become taxable. Lump sum distributions also present a special compliance problem because if no tax is withheld when they are paid, the recipient may have insufficient cash to pay the substantial tax that may be due when his return for that year is filed.

The withholding provisions of §131 of the bill are an appropriate response to these noncompliance problems, except in one limited respect. It might well be more appropriate in the case of the mandatory withholding with respect to lump sum distributions to provide for withholding at a flat rate, or only at two rates -- a very low rate (say 10%) for small lump sum distributions and a higher rate (perhaps 20%) for larger lump sum amounts. This would more likely avoid substantial over-withholding arising from the complex averaging, capital gain, and exemption features of the taxation of such amounts under existing law.

Title II

Sec. 202 -- Paperwork Reduction

This provision would exempt rules and regulations promulgated under the Internal Revenue Code, and Internal Revenue Service tax forms, from approval by the Office of Management and Budget under the Paperwork Reduction Act of 1980. This provision is extremely important and should in all events be enacted.

The tax administration process is not the type of regulatory activity to which the Paperwork Reduction Act was directed. Internal Revenue Service rulings, regulations, and tax forms provide essential guidance to taxpayers; the interests of taxpayers are served by greater rather than lesser activity in issuing and improving such rulings, regulations, and forms. The development of these materials requires extraordinary expertise, experience, and judgment by the Treasury Department, and the Office of Management and Budget does not have the necessary background to provide adequate review. OMB review would result in unnecessary delays and conflicts. Groups such as the Taxation Section of the American Bar Association and the American Institute of Certified Public Accountants provide intensive and constructive criticism of all such materials. There is no widespread concern among tax experts that the Treasury Department has issued more rulings, regulations, or tax forms than the Internal Revenue Code requires.

Sec. 203 -- Report on Forms

This provision would require the Treasury Department to report to the Congress by May 31, 1983, as to modifying its forms to achieve greater accuracy in the reporting of income and the matching of information returns with taxpayer returns. Such a report would be a useful document. This provision should be enacted.

The Internal Revenue Service in the last several years has contracted for a study of the Form 1040 to simplify its format and instructions, and some very ingenious work has been done under this contract by a multi-disciplinary group organized by the contractor. (In this matter, I speak partly from self-interest because I personally am part of that group. It is such a useful undertaking, however, that I cannot avoid making reference to it.) A testing of the product of that contract on a sampling basis is presently underway. Hopefully, the Service will press ahead with that type of development.

* * *

In conclusion, I strongly endorse the general objectives which S. 2198 seeks to achieve. I will endeavor to assist this Subcommittee in every possible way in the evaluation of these and any further proposals to narrow the compliance gap and deal with the broader underground economy problem. The Section of Taxation of the American Bar Association, of which I am a member, will press forward with its extensive efforts to provide assistance in these matters. Thank you.

LAW OFFICES OF
MILLER & CHEVALIER
CHARTERED
1700 PENNSYLVANIA AVENUE, N. W.
WASHINGTON, D. C. 20006
AREA CODE 202
626-5800

ROBERT N. MILLER 1879-1968
STUART CHEVALIER 1879-1956

NUMA L. SMITH, JR.
JOHN S. NOLAN
RAPHAEL SHERFY
JOHN M. BIXLER
CLARENCE T. KIPPS, JR.
JAMES F. GORDY
PHILIP S. NEAL
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ROBERT L. MOORE, II
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F. SHAUN BURNS
JAMES P. TUITE *
GERALD B. FLEMING
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B. JEAN LIKES
JOANNE THOMAS ASBILL
STEPHEN W. COMISKEY
ALAN C. BROWN
DAVID B. CUBETA
VINCENT I. POLLEY
SARA F. WALSH
RUTH E. KENT
HARRY J. CONAWAY
VICTOR THURONYI
STEVEN S. DIAMOND
JOHN C. DUGAN

* NOT ADMITTED IN D. C.

NEW YORK ASSOCIATE
EVERETT, JOHNSON & BRECKINRIDGE
20 EXCHANGE PLACE

COUNSEL
DAVID W. RICHMOND
CHARLES T. AKRE
BARRON K. GRIER
EWING EVERETT
MALCOLM JOHNSON

WRITER'S DIRECT LINE
626-5700

April 16, 1982

Honorable Robert J. Dole
Chairman, Senate Committee
on Finance
Washington, D.C. 20510

S. 2198

Dear Senator Dole:

My edited testimony is returned herewith. I would like to supplement my testimony on two matters, and I ask that this letter be included in the record.

In endorsing §113 of S. 2198, dealing with restrictions on interest on overpayments, at pages 11-12 of my statement for the record, I overlooked one very important defect in this provision. Interest should not be denied on overpayments attributable to net operating loss, capital loss, or unused credit carrybacks from the date of overpayment until the date the claim for refund is filed where the claim is filed within the time (including extensions) for filing the return for the tax year which gives rise to any such carryback.

The returns of most corporations traditionally are not filed until 8-1/2 months after the close of the taxable year, pursuant to extensions of time to file uniformly granted, because of the extreme difficulty of assembling all the necessary factual information (including that with respect to foreign branches and subsidiaries). Hundreds of different subsidiary corporations or branches, possibly engaged in many difficult types of business, may be involved in the case of a typical large, public corporation. It would be unreasonable to expect such a business taxpayer to be able to file its return in complete and adequate form much before the end of such period, given the extraordinary complexities of the U.S. income tax system.

It would be inequitable to deny interest on overpayments attributable to carrybacks for this interim period, and proposed §113 would create unwise pressures in these circumstances to rush the filing of the return. This could result in much unnecessary waste in the tax administrative process, both for the taxpayer and the Internal Revenue Service. Section 113 provides that the return must be filed in "processable" form. Extreme controversy would arise whether a corporate return filed as soon as possible after the end of the taxable year giving rise to the carryback, to avoid the loss of interest, would have met this standard. Corporate management would feel obligated to incur whatever overtime and other added costs were necessary to avoid loss of interest.

The interests of both business and the Government are better served by complete, carefully prepared returns, and it is for this reason that the 8-1/2 month period for filing the return has been given. Section 113 would upset this process without adequate reason.

Accordingly, I strongly recommend that §113 be amended to incorporate the exception described above. It might be appropriate, however, to deny interest for overpayments attributable to carrybacks for any period by which the filing of the claim for refund is delayed beyond the maximum period (with extensions) for filing the return for the taxable year giving rise to carryback. This would address the essential purpose of the provision to prevent taxpayers from unduly delaying the filing of a refund claim to obtain a favorable rate of interest on overpayments.

The second matter on which I wish to comment further is §125 of the bill, the penalty for substantial understatements of tax attributable to items not disclosed in the return. I expressed reservations about the application of this penalty with respect to activities of a trade or business (pp. 20-21 of my written statement), and on reflection, I wish to state these reservations more strongly.

In the case of business returns, particularly corporate returns, this penalty is likely to do much more harm than good when applied with respect to anything beyond "omissions from gross income", as that concept exists for purposes of Code §6501(e), and if applied to any extent to corporate returns (except, possibly, personal holding companies or Subchapter S corporations).

In the case of corporations, Schedule M of the return requires reconciliation with the taxpayer's income per books and financial statements. This serves indirectly to disclose the existence of many matters of interest to the Internal Revenue Service. Shareholders and other financial considerations provide a healthy discipline with respect to the reporting of income and the accrual of costs and expenses for financial statement purposes.

In addition, the Internal Revenue Service provides highly-sophisticated audit coverage in the case of larger corporations, and it is unlikely that such taxpayers will have deficiencies attributable to items that the IRS could not discover. The Committee's data suggest that underreporting in the corporate area is not a significant part of the "compliance gap".

If section 125 were applied in this context, it would force business taxpayers, out of an abundance of caution, to make extensive "disclosures" in the return, and after a short period of time, the "Cry Wolf" syndrome would set in and such disclosures would become of little or no use to the IRS in actual practice. There would, however, be an enormous waste of time and effort both to taxpayers and to the IRS in the process, with doubtful, if any, gains to good tax administration.

This penalty is better suited to the situation where there has been an omission of gross income within the scope of that concept as it has developed under Code §6501(e). Even then, I recommend also that it be made completely inapplicable to corporations other than personal holding companies and Subchapter S corporations. The existing negligence and fraud penalties provide adequate protection to the Government in such cases.

Sincerely,

John S. Nolan

John S. Nolan

Senator GRASSLEY. Senator Dole.

Senator DOLE. I have a number of questions.

There is one thing, that is just a matter of record. I am sure you are all experts, you have all been policymakers in this area so your testimony is certainly going to be carefully considered.

We have had some criticism of this proposal because they say we are unfairly dealing with low-income taxpayers. But, as I look at the areas we are trying to cover, most of it is addressed to capital gains reporting, bearer bonds, T-bills, corporate tax fraud, tax shelters. I suggest that we are not trying to focus on low-income taxpayers.

Second, as I think Don Alexander pointed out as did Buck Chapoton, we get a 99-percent compliance with the wage earners, and a lot of those are in the low-income area. It would seem to me that just the reverse is true—what we are looking at are those who may be in upper brackets, maybe not completely upper brackets, who fail to report income.

Is that how you look at the bill generally? You have some problems with it, but is it a fair criticism to indicate that we are after low-income taxpayers in this proposal?

Mr. ALEXANDER. Well, you don't exclude them.

Senator DOLE. They are not excluded; no. I don't think they should be.

Mr. ALEXANDER. Right. So that's the problem right there. If there were a way of identifying them and excluding them, then you would eliminate the problem but you would greatly weaken the bill.

So the fact that they are in there means that you have to think about the application of certain of these provisions that we have discussed; in a low-income taxpayer context. And some problems are created by certain of them, as has been discussed with you this morning.

Mr. HICKMAN. Whether the bill rests heavily on low income taxpayers depends on how you define "low income." One of the things that has happened over a period of several decades is that through rising real incomes and inflation a great many more taxpayers are in what might be called the middle brackets than there used to be. While we don't have any data breaking down the gap by taxpayer income bracket, I would suspect that if we did, we would find that the great bulk of the dollars that we are talking about are not really in the top brackets but somewhere in the middle. It is the people who have a few dividends that they don't bother to report, that kind of thing. The people who have a lot are more likely to put them in.

Mr. NOLAN. My personal evaluation is that there are no significant burdens on lower income taxpayers in this bill, except possibly in the minimum nonfiling penalty, as to which I have suggested that more consideration is needed.

Senator DOLE. Right. There are about 5 million nonfilers or something, and I know what it costs the IRS, about $80 per return, to track them down. So I don't know where we would come out on that.

The ABA, Mr. Nolan, is trying to figure out some way to properly revise the rules for auditing partnerships. Is that near resolution?

Mr. NOLAN. Yes; we have been working very intensively with the Internal Revenue Service over the past year on that proposal, and we are at the point of completing it. It will soon be ready for submission to this committee, as was indicated earlier.

Senator DOLE. Good. I had hoped we might have that as we get into the markup.

There are a lot of areas that will be controversial, but we will have particular controversy with reference to charged tips. Now, that first occurred, Mr. Alexander, I think, during your administration as Commissioner.

Mr. ALEXANDER. Yes; it did.

Senator DOLE. There must have been some reason for you to go after that particular area.

Mr. ALEXANDER. We were very seriously worried about a very serious gap in compliance in that area. And we thought that this was an appropriate course to follow.

We issued a ruling, because we thought we could handle this by ruling, calling for the reporting of charged tips by the waiter or waitress, the person involved, to the employer which could be then lumped with what that person otherwise reported and subjected to the strange withholding process where the employer withholds only on what the employee tells the employer to withhold upon. That issue aroused fierce controversy. In this room, at a markup session, thanks to your letting me do so, Mr. Chairman, I attempted to make the Internal Revenue Service argument. An argument to the contrary was made by someone representing the other side at that markup, and that argument was accepted.

You are going to hear a lot more about this one, and you will hear a lot more about it this morning. It is a highly controversial matter; but I am convinced that, despite the fact that this indeed involves some low-income people and some problems, that those problems can be solved through a tight committee report with tight directions to the IRS to bend over backward being fair. And I think the IRS will follow those directions. And I think you can greatly improve compliance in this area without putting a tremendous burden and unfair taxes upon the backs of the waitresses and waiters in this country.

Senator DOLE. Well, I agree with that, and we have had all kinds of proposals on the way to get at it. I think Mr. Nolan had a proposal that I have been considering. Maybe we ought to put the burden on the taxpayer, that they can't claim the deduction without some verification. One way or another we are going to get at the problem. We are not going to exempt a certain class of people because they are in a certain business from paying taxes.

I think, Mr. Nolan, when you were in Treasury, you were there when the excise tax on investment income for private foundations was imposed. The purpose of that tax was to allocate the cost of securing compliance to the class of responsible persons. Maybe an excise tax is an alternative to the charged tip proposal and place an excise tax on those businesses with extensive noncompliance. They are all going to come in here this morning and say, "Oh, we can't do this; this is too burdensome." We understand that, but they don't offer any alternative. So they ought to be prepared to offer some alternatives.

Do you recall the excise tax?

Mr. NOLAN. I certainly do, Senator Dole, and I would not exclude any possibility in this area. I think that a noncompliance rate below 80 percent is a disgraceful situation, and some strong measures are absolutely necessary. We must find a way to see that income which is earned is subject to taxation.

Senator DOLE. I don't want to use the three-martini approach, but that has also been suggested, that if you lower the amount that business people can deduct, maybe they won't leave a tip. That's one way to address it, but that's the Kennedy approach. I don't agree with that approach.

Mr. ALEXANDER. We ought to have a better approach than that, sir.

Senator DOLE. Well, I hope so, and I see a man in the back of the room there that may have some ideas.

I may have other questions. I don't want to bother you with written questions. I know you are volunteering to appear here, and we appreciate that, but we will be asking your counsel, maybe, as we proceed with the markup of this legislation.

Senator GRASSLEY. I don't have any questions, but I surely want to thank you for your testimony. It has been very beneficial. I know that you all served in Government in these particular areas for a long period of time, and you have had now even more of a period of time to reflect on that experience. So that makes your testimony that much more valuable to us.

Thank you very much, each of you.

Our next panel consists of Mr. Richard Benefield, general manager of the Hotel Magee, Bloomsburg, Pa., on behalf of the American Hotel & Motel Association; and Mr. Robert Neville, president of the National Restaurant Association; and also Mr. Robert E. Juliano, legislative representative, Hotel Employees & Restaurant Employees International Union, AFL-CIO, and he is from Cincinnati, Ohio.

I would ask if Mr. Benefield would go first, and then Mr. Neville, and then Mr. Juliano.

## STATEMENT OF RICHARD BENEFIELD, GENERAL MANAGER, THE HOTEL MAGEE, BLOOMSBURG, PA., ON BEHALF OF THE AMERICAN HOTEL & MOTEL ASSOCIATION, WASHINGTON, D.C.

Mr. BENEFIELD. I am Richard Benefield, general manager of the Hotel Magee in Bloomsburg, Pa., which is a 64-room hotel serving a community of 10,000 people, having been in operation since 1855. I am also a member of the Governmental Affairs Committee of the American Hotel & Motel Association, and I am here representing that association.

I testified before this committee in 1978. At that time there was a bill, S. 1674, supported by some members of the Finance Committee, which prohibited the IRS from requiring the employer to record and report charged tips. Now we are dealing with opposite recommendations.

My principal problem with the bill, as a small hotelkeeper representing thousands of small hotels and restaurants, is that it adds an onerous burden of recordkeeping and bookkeeping.

At least in my business we have had a very substantial shrinkage of margins of profits. Your colleagues from Pennsylvania can tell you and you know that our part of the country has been hurt badly by the economy. And to add an extra person to basically take care of this particular matter would certainly be a hardship on us and on many, many other small innkeepers and restaurateurs.

We know that the tips are really the property of the employee. We act ony as a conduit in passing those tips to the employee. The Congress has recognized that all the way through, from the time we started this kind of taxation, I believe around 1917. They recognized it again in 1964 and again in 1978.

Congress did not intend that the employer be saddled with a reporting and recordkeeping burden of this nature, which this legislation seeks now to impose.

Another thing that amazes me is that in 1978 the Treasury-reported estimate was that they would lose less than $5 million in tax receipts. Now you are saying that the Treasury will recover some $250 to $300 million in tax receipts by requiring employers to report charged tips. Now, we have had some inflation—but not that much.

So, in summary, the information as to the amount of tip income received by a tipped employee is solely within the knowledge of the tipped employee. The responsibility for reporting the amount of tips received by the tipped employee, under longstanding provisions of law, has been solely the responsibility of the tipped employee, whether the reporting was directly to the IRS or, as later required by the law, to be made by the employer.

The existing law if properly enforced places an appropriate penalty on a tipped employee for failure of the employee to report or for falsifying his reporting. The obligation has always been placed where it properly should be placed—namely, on the person who solely knows the amount of tips received. To require an employer to report charged tips would require that employer to report unreliable information on the tip income of an employee. I don't know of a more untenable position in which to place an employer with his or her employees, or a greater blockbuster to ruin morale in an employer's workplace.

We do not think the law should be changed nor do we believe that such a proposed change, which may very well result in a greater use of cash tips and a reduction in the use of charged tips, will help IRS enforcement or increase revenue.

Thank you very much.

Senator Grassley. Mr. Neville.

## STATEMENT OF ROBERT NEVILLE, PRESIDENT, THE NATIONAL RESTAURANT ASSOCIATION, WASHINGTON, D.C.

Mr. Neville. My name is Robert Neville. I am the president of the National Restaurant Association, Mr. Chairman.

I would ask that my statement be included in the record. I would just like to concentrate on one or two points in the statement, if I may.

Senator GRASSLEY. Yes. It will be as a matter of normal procedure.

Mr. NEVILLE. The thing that has disturbed me the most in listening to all of the witnesses this morning is that no one seems to talk about the distinction that exists in the law between tips and the ordinary wages and income that are paid out by an employer to an employee.

No one seems to understand that when a tip, whether it be a charged tip or a cash tip, is received by an employee, that is income or wages to an employee only to the extent that that employee retains that tip. That brings into play the tip pooling and tip splitting arrangements that are probably as varied as anyone can possibly imagine.

Senator DOLE. If an employee gives a part of that tip to somebody, that's deductible to the employee—not excludible. That is, the tip is includible in the taxpayers' gross income, is it not?

Mr. NEVILLE. Well, it's not income to him. It never becomes income until he determines what portion of that tip he is going to retain for his use. And that's what poses the problem. There isn't an employer going who knows exactly what tipping or tip splitting or tip pooling arrangements his individual tipped employees may have.

Let me give you an example. I know of situations where waitresses have seven different people that they split tips with—service bartenders, bus personnel.

And, incidentally, while I am talking about that, when you start assessing the amount of revenue that you are going to get out of all this, assuming that IRS is correct that there is $2.5 billion or whatever unreported income, when you start assessing the amount of tax that is going to be realized out of that, when you look at the tip splitting and tip pooling arrangements, a lot of that money is not going to any high bracket taxpayers, I can assure you. It's going to bus personnel and some of the lower paid personnel in the establishment.

Senator DOLE. Well, that's true of anybody who has taxes withheld from their wages. He might be right next door running the elevator and making $15,000 a year. He is low income. That's not a good argument.

Mr. NEVILLE. It is, Senator. What I am talking about is that this money ultimately, great portions of it, funnels down to people in the lowest tax brackets. That's the point that I'm making. You can't automatically assume that you are going to get 20 or 25 percent of $2.5 billion, is my point. When you have tip splitting and tip pooling and you don't know what's going to happen to that money, it's very difficult for you to assess just how much money you are losing or how much you are gaining.

I would just like to emphasize this point, because it's a serious consideration for the employer, and it's a serious consideration for the employees concerned. We have no control as employers over what these pooling or splitting arrangements may be. They can organize them in any way they want to.

I can describe a situation of a club that I have heard of where all the employees got together and designated one of their members to receive all charged tips. The employer was to turn over all tips to that employee who was their treasurer. It's all put into a fund, and they determine how it's going to be divided up. But this is an understanding that they have, and the employer is in no position to disturb it. Well, under the charged tip rule, all of that would be credited or reported by the employer, the total tip income of that establishment, to that one employee. It's a graphic demonstration of just how difficult this particular problem can be when you attack it.

If I can have another minute, I would just like to point out that part of the problem is that tips fit poorly if at all into the kind of payments contemplated in section 6041. Section 6041 requires the employer or anybody in a trade or business making payments to provide a true and accurate statement of those payments, and those include rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. And if you look at the law, Senator, it says "or other fixed or determinable gains, profits or income."

Now, the employer doesn't know where these tips are ultimately going to rest and to whom to attribute these wages or income. He looks, then, at section 6051 which requires him to put tip income on the W-2 form, and he is again restricted to reporting the tip income that is reported to him by the employee. And there's a good reason for it: Congress recognized it when they said the employee is the only one who knows what he does with this tip.

It is not a very simple proposition. It's entirely different from ordinary wages and income, and needs to be addressed very carefully. It is not one that lends itself to a simple solution.

Thank you, Senator.

Senator GRASSLEY. Thank you, Mr. Neville.

Mr. Juliano.

## STATEMENT OF ROBERT E. JULIANO, LEGISLATIVE REPRESENTATIVE, HOTEL EMPLOYEES & RESTAURANT EMPLOYEES INTERNATIONAL UNION, AFL-CIO, CINCINNATI, OHIO

Mr. JULIANO. Mr. Chairman, thank you for allowing us to be here, and thank you for putting our statement in the record.

We have had the privilege of appearing before this committee many times. I'm somewhat saddened that the first time we've had to appear before new leadership we are thrust into a position, unfortunately, of opposing some specific proposals, when in an overall sense we share your desire sincerely to raise revenue and understand your concerns.

This issue specifically has been visited twice by the Congress. The IRS has appeared today, and Treasury. They have claimed revenue figures which I think have changed in each succeeding time they have appeared. They may have given to you indication of where they have achieved these statistics—they certainly have not been willing to share them with us—and I seriously question that the amount of supposed revenue that will accrue to the Treasury if this particular section is enacted is in fact accurate.

What we have talked about specifically, Senator, is an area of tip splitting and tip pooling. There was one gentleman before from GAO who was asked a question about tip splitting and tip pooling, and he candidly and honestly said he did not know what the situation was. That's been traditionally the position of the IRS right along.

Don Alexander appeared earlier and talked about his experience when he was the Commissioner and said that you should proceed on your course, and also that "your friendly IRS Commissioner"—I think was the term he used—"would help you along the road." Which, of course, is nice.

Now, what was neglected to be mentioned, I think, was the position that they have maintained consistently about the tip splitting, which they have not shared with you, and I would like to take a minute to do.

It is that if a waiter or waitress gets a $10 tip from a charge slip, and the custom and practice traditionally has been to share that with the busboy or busgirl, with the cook, with the bartender perhaps—a service bartender who has no public customers—that in fact is a longstanding practice which Congress recognized going back to 1965 when it was the first time that our members were covered under the Fair Labor Standards Act.

The last proposal that emanated from the IRS and Treasury, which was soundly defeated and opposed by your committee and the Ways and Means Committee, was that the waiter would secure a receipt from the busboy or busgirl each time they got into that tip splitting situation. And that was their answer to how to solve this problem of tip splitting.

It is our estimation that last year there were about 600 million charged meals. And if you assume just three people splitting, you are talking about 1.8 billion individual paper transactions.

The thrust, further, of the IRS was: When the waiter or waitress would come in, if they would be called in for an audit, that obviously it would be difficult when you have a labor turnover of 300 or 400 percent among bus personnel and people in that area, that our people would have no way of substantiating, of course, that the slip that they had would in fact be valid because who would know where the bus person might be at that particular point in time?

Obviously, then, the Service says, "Your request for a deduction is disallowed," and therefore you have a $10 charge tip, and even though you put $6 in your pocket you are going to pay on the whole $10.

They have used the same argument consistently. They have not changed their proposal to us one iota. And I submit to you that the same area that is being considered today is exactly what came before your committee twice before and was soundly rejected.

[The prepared statements of the previous panel follow:]

Statement of the

American Hotel & Motel Association

Mr. Chairman and Members of the Subcommittee:

I am Richard Benefield, General Manager of the Hotel Magee in Bloomsburg, PA. I am also a member of the Governmental Affairs Committee of the American Hotel & Motel Association. I am here representing the Association.

The American Hotel & Motel Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico and the Virgin Islands, having a membership in excess of 8,200 hotels and motels accounting for over one million rentable rooms. Inclusive in our membership are all of the major hotel and motel chains.

I testified on this same issue before the Senate Finance Committee in 1978. At that time there was a bill, (S. 1674) supported by some members of the Finance Committee, which prohibited the IRS from requiring the employer to record and report charged tips. Now, we are dealing with opposite recommendations.

We oppose S. 2198, "Taxpayer Compliance Improvement Act of 1982", because of its onerous recordkeeping requirements and because it departs from placing the sole responsibility of reporting tip income on the person who receives the tip income. Unlike 1978, your bill does not require withholding but, to us, it would seem to be the next step once you have changed the reporting burden of the law. In addition, your bill has an exemption. Those very few hotels or motels who would have 5 employees or less, are likely to be small non-credit card establishments.

I am sure you are familiar with the history of the reporting of tip income but I would like to briefly review it here.

From the inception of the tax laws in 1917 until 1965, employers were not involved in reporting on or withholding taxes related to tip income. Employees were merely required to report their tips and pay taxes thereon.

In 1965, Congress changed this by making employers report tip income on the employee's W-2 Form for withholding and social security purposes - but again, the report was based on declarations to the employer by the person who received the tip income.

Congress did not do this lightly. The House Report said that, "the only equitable way of counting tips..(would be) on the basis of actual amounts of tips received and that the only practical way to get this information (would be) to require employees to report their tips to the employer. (H.R. Report N. 213, 89th Congress, Second Session 96 (1965).)" Section 6053 was added to the code in 1965 for this purpose.

Congress also recognized the common practice of tip splitting and tip pooling and determined that only tips received by an employee in his own behalf would constitute wages or income to that employee. Any portion of a tip which an employee splits or gives to a tip pool is income to the ultimate recipient. As a result of this determination, section 6051 of the code was amended in 1965 to provide that an employer's report of tip income on Form W-2 "shall include only" that tip income reported by the employee to his employer.

The entire legislation history of the 1965 amendments as it relates to taxing and reporting tip income reflects a thorough understanding by Congress of the practices and customs of tipped employees and a deep concern for the accounting problems these amendments would present to employers. This concern was reflected in the House Committee Report in these words:

> "The employee would be required to report to his employer in writing the amount of tips received and the employer would report employees' tips along with the employees' regular wages..A provision is included under which the Secretary of the

Treasury or his delegate is authorized to issue regulations under which the employer will be permitted to gear these new reporting procedures into his payroll. It is the understanding of your Committee that regulations will be issued along these lines to the end that the procedures required of the employer with respect to this reporting requirement will be minimal." (House Report No. 1548, 88th Cong., 2nd Sess. 11 (1964). (Emphasis added.)

One cannot argue that Congress did not anticipate or have knowledge of charge tips as opposed to tips received directly from the consumer, for the House Committee Report specifically refers to charge tips in these words:

"The employee would be required to report to his employer in writing the amount of tips received and the employer would report the employee's tips along with the employee's regular wages. The employee's report to his employer would include tips paid to him through the employer as well as those received directly from customers of the employer." (House of Representatives Report No. 312, 89th Cong., 1st Session (March 29, 1965). (Emphasis supplied).

Congress, then, did not intend that the employer be saddled with a reporting and recordkeeping burden of this nature which this legislation now seeks to impose. For almost two decades the law and the practice has been for the employee to report his tips to the employer.

Despite existing law which requires tipped employees to maintain accurate records of tip income and to make reports of such income in writing to their employers at least once a month, you now propose to require hotels and motels to keep records of all tips charged on credit card slips! In addition, you now propose that the hotels and motels must be the ones to report all of these charged tips for each individual tipped employee to the IRS! This is a total reversal of present law and contravenes the entire history of tip reporting responsibility.

Tips are, and always have been, the property of the employee. The employer is merely a conduit between the customer and the employee. What you want now is for the employer to be an IRS secret agent, checking and reporting on an unknown quantity; i.e., the tip income of the employee - the actual amount of which is known only to the employee.

A credit card charged tip is absolutely no indication of income to an employee. The practice of tip splitting and tip pooling assures that this is the case. The charged tips may or may not have gone to the employee who presented the check - we have no way of knowing. The charged tip is an inaccurate indicator of where that tip went.

In 1978, when the Senate Finance Committee was considering this very issue the Committee Report said "The Committee believes that the practices presently followed by employers in reporting their employees tips to the Service is appropriate and that the new rules proposed by the Service present an unnecessary complication for employers".

At the same time the Senate Finance Committee estimated that by not requiring employers to record and report charged tips the Treasury would lose "less than $5 million" in tax receipts. Now, you are saying that the Treasury will recover some $250 to $300 million in tax receipts by requiring employers to report charged tips. We all agree that inflation has been too high between 1978 - 1982 but inflation on tip practices have not changed so much as to justify this drastic difference in numbers.

We strongly believe that existing law is more than adequate for the IRS to increase compliance with the income reporting laws. As we mentioned, it is under present law clearly stated that it is the employees' sole responsibility to report to the employer his or her tip income. While this Committee and the entire Congress in 1978 found it inconceivable to place this unfair burden of reporting on employers, the law was revised to require us for the first time to keep those charged tip receipts for IRS audit purposes and this we have done. Now, the Congress is proposing a significant increase in IRS audit capability including the addition of 5,000 IRS employees. All of the ingredients are present for increased compliance with the law: the law is already on the books that the employee must report his or her tip income; the employer is already required to keep charged tip receipts for IRS audit purposes; and finally, the IRS has and will have increased audit capability to scrutinize those people who are allegedly consistently under-reporting their income.

The only reason that we surmise that you now propose for the employer to keep and report charged tips is because the IRS has been incapable of enforcing the law. It seems unfair to make us an arm of the Government just because the IRS is not doing an adequate job.

In summary, we reiterate:

The information as to the amount of tip income received by a tipped employee is solely within the knowledge of the tipped employee; the responsibility for reporting that amount of tip income received by a tipped employee under long-standing provisions of law has been solely the responsibility of the tipped employee - whether the reporting was directly to the IRS or as later required by law to be made to the employer. The existing law if properly enforced places an appropriate penalty on a tipped employee for failure of an employee to report or for false reporting. The obligation has always been placed where it properly should be placed - namely on the person who solely knows the amount of tips received. To require an employer to report charged tips would require that employer to report unreliable information on the tip income of an employee. I don't know of a more untenable position in which to place an employer with his or her employees or a greater blockbuster to ruin morale in an employer's workplace. We don't think the law should be changed. Nor, do we believe such a proposed change, which may very well result in a greater use of cash tips and a reduction in the use of charged tips, will help IRS enforcement.

NATIONAL RESTAURANT ASSOCIATION

The National Restaurant Association opposes the provision of S. 2198 requiring employers to report all charged tip income separately to the Internal Revenue Service, for the following reasons:

- Tipped employees would have massive new paperwork problems. Under voluntary tip pooling arrangements (with which under law the employer cannot be involved), the tip charged on one slip is ultimately divided and distributed among several employees. All these employees would be forced to obtain receipts from each other to substantiate their shares of tip income.

- Employers would be unable to accurately report any individual's income, since tip pooling distributions are not reflected on charge slips, and since the employer would be reporting much of the same income twice - from the charge slip totals and again from the employee's own tip reports. In addition, the new records to be kept and reports to be filed will cost employers significant time and money, since even small employers have indicated to us that they would need more staff time to meet these new requirements.

- The IRS already requires employers to retain all charge slips for audit purposes, so IRS already has access to the information that would be reported by employers.

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NRA's witness at the hearing is the association's Acting President Robert B. Neville.

STATEMENT OF THE NATIONAL RESTAURANT ASSOCIATION
ON S. 2198, THE TAXPAYER COMPLIANCE IMPROVEMENT ACT
TO THE SENATE FINANCE SUBCOMMITTEE ON
OVERSIGHT OF THE IRS, MARCH 22, 1982

The National Restaurant Association is a non profit trade association with headquarters in Washington, D.C. It offers programs in public affairs, education and research to its 10,000 members, who operate more than 100,000 foodservice facilities.

We are happy to have the opportunity to comment on the Taxpayer Compliance Improvement Act (S. 2198). Our particular concern is Section 103 of the bill, which would establish new requirements for the reporting of tip income.

The NRA appreciates the problem S. 2198 seeks to correct. We have long advocated balanced federal budgets, so we believe any efforts to reduce budget deficits deserve careful consideration. And no business organization can condone under-reporting or tax evasion in any form.

However, largely because of the complex and little-regulated practice of tipping, the employees of the foodservice industry are charged with far more than their share of the blame for under-reporting. The Internal Revenue Service figures accompanying this bill perpetuate the belief that tipped employees are less-than-honest, estimating that less than 20 percent of all tip income is reported. These are "preliminary and unpublished estimates by IRS" and are unsubstantiated by any more reliable data. Since we don't know how these figures are derived we cannot, for example, perform a similar study to substantiate or refute the IRS findings. And IRS has been reluctant thus far to attach a dollar figure to under-reporting of tips.

Employee Responsibilities

However, assuming that tip-reporting is a problem, serious questions are raised about whether the government regulatory burden to be placed on tipped employees is justified. The majority of these employees participate in voluntary tip pooling or tip sharing arrangements. The employer frequently does not know the extent or nature of these arrangements, has no desire to interfere with them and, under Department of Labor regulations, is specifically prohibited from exercising any significant control over tip pooling. The arrangements themselves vary among different individuals, shifts and workplaces.

The tip amount added on each charge record is ultimately divided and distributed among several employees. The waiter, for example, may have agreed to share a portion of this amount with a bus person, service bartender, captain, hostess or other service personnel who generally are not tipped directly. These employees would, under this proposal, be forced to obtain receipts from each other for each transaction to substantiate their shares of tip income; obviously, the charge record would hardly tell the whole story about who made how much on each sale. Multiply this by the one million tipped employees of eating and drinking establishments and by the estimated 600 million charge transactions in restaurants every year and you can understand the massive new recordkeeping that tipped employees and their employer's would have to perform.

In the past, Congress had recognized the impracticality of forcing tipped employees to engage in paperwork on a scale so far beyond that required of any other type of employee. In enacting the 1965 amendments to the Internal Revenue Code, Congress decided that the only practical way to determine actual tip income for tax purposes was to require the tipped employee to report the amount received to his or her employer, and Section 6053 of the Code was added for this purpose.

Even after IRS efforts in 1975 and 1976 to increase reporting and withholding requirements for charged tips, Congress reaffirmed in 1978 that employee reporting responsibilities should be limited to a declaration of tip income to the employer. Assuming that under-reporting was a problem throughout the period since 1965, it is difficult to understand why Congress should now reverse itself and add significant new recordkeeping burdens on employers -- and employees.

Furthermore, employers would continue to report all tips reported by the employee, in addition to making a separate report of charged tips. There will be a substantial overlap between these two reports, with the same charge tip being counted once in the employee's report and again in the charged tip report. This duplication and overlap cannot provide IRS with accurate information and will substantially overstate tipped employee's income.

<u>Employer Responsibilites</u>

This discussion of tip pooling is also relevant to the employer's new responsibilities under S. 2198. We have seen that under tip pooling, the charge record is an inaccurate reflection of actual tip income to a particular individual. If you require the employer to report what is shown on the charge record, you require the employer to report for an employee a tip income amount he or she knows to be inaccurate and you also require that employer to violate the statute's command to "render a true and accurate return," and to ignore Code Section 7204, which provides penalties of fine and imprisonment for "willfully furnish[ing] a false...statement" concerning income.

The Technical Explanation of S. 2198 acknowledges the existence of the problem when it says, "the amount reported by an employee on his tax return may be different, or course, from that reported by the employer because of pooling and other tip sharing arrangements." That is all the Technical Explanation says about this disparity; it does not explain what logical use IRS can make of information which the agency itself acknowledges to be inaccurate.

Part of the problem is that tips fit poorly, if at all, into the kind of "payments" contemplated by Section 6041. Tips do not originate with the employer, as do wages, salaries, etc. and the employer has no control over their amount - the employer serves as conduit for a payment from customer to employee. With this proposal, the employer would become a policeman, taking over from IRS an enforcement function that only IRS is capable of performing and, in so doing, creating a source of conflict and disagreement between employee and employer.

In addition, the new records to be kept and reports to be filed will cost employers significant time and money, and add to their government regulatory burden. Even small restaurant operators (and the bill would cover any employer of six or more) have indicated to us that they would have to hire another person or pay present staffers for longer hours worked to compile the necessary data.

IRS Already Has Access To Charged Tip Information

Creating conflict, expense and paperwork for the employer might be justified if the employer was privy to special information to which the IRS was not. But, concerning tips and their ultimate distribution, the employer knows less than the employee or the IRS. And the employer is required, by Code Section 6001, to retain charge receipts and statements (of tip income) by employees, the purpose being to facilitate IRS audit. So charge tip information is already available under current law to the IRS. The agency has neglected to make much use of this information over the years, and has yet to explore the possibilities of increasing collections by using this information to which it already has access.

In summary, we believe that Section 103 of S. 2198 imposes unreasonable recordkeeping and reporting burdens on employees, compels employers to violate statutory requirements to file accurate returns, and only duplicates data which IRS already had access to, but has not utilized. For these reasons, we ask the Subcommittee to eliminate Section 103 from the final bill.

RP/dm

SUBMITTED BY:

ROBERT E. JULIANO
LEGISLATIVE REPRESENTATIVE
HOTEL EMPLOYEES AND RESTAURANT
EMPLOYEES INTERNATIONAL UNION

MR. CHAIRMAN, ON BEHALF OF OUR GENERAL PRESIDENT, EDWARD T. HANLEY, AND THE 450,000 MEMBERS WE PROUDLY REPRESENT, MAY I SAY WHAT A PLEASURE IT IS TO APPEAR BEFORE THIS DISTINGUISHED SUBCOMMITTEE REGARDING THE TAXPAYER COMPLIANCE IMPROVEMENT ACT.

AT THE OUTSET, I APPLAUD THE COMMITTEE'S EFFORT TO LOOK AT AREAS WHEREBY ADDITIONAL REVENUE COULD BE RAISED AS A MEANS OF REDUCING THE BUDGET DEFICIT. SINCE OUR INTERNATIONAL UNION HAS BEEN ACTIVELY INVOLVED IN SOME MAJOR TAX LEGISLATION OVER THE PAST FEW YEARS, WE WOULD LIKE TO DO WHATEVER WE CAN TO ASSIST THE CONGRESS IN THEIR EFFORTS TO RAISE REVENUE.

IN A GENERIC SENSE IT IS OUR STRONG BELIEF THAT THE FEWER ITEMS IN A TAX BILL, AND THE BROADER THE REVENUE BASE, THE LESS CONTROVERSY SUCH LEGISLATION INCURS. CERTAINLY THE SUBJECT OF THE UNDERGROUND ECONOMY RAISES A LOT OF INTERESTING POINTS. HOWEVER, WE DO NOT FEEL THAT THE MATTER OF CHARGE TIPS PROPERLY BELONGS IN THIS CATEGORY. THEREFORE, ALTHOUGH WE HOPE TO BE ABLE TO WORK WITH ALL OF YOU ON MEANINGFUL TAX LEGISLATION, WE MUST VIGOROUSLY OPPOSE YOUR EFFORTS TO AMEND THE CHARGE TIPS PROVISION, SINCE THE CONGRESS HAS REVIEWED THIS MATTER TWICE IN THE LAST FOUR YEARS AND WISELY REJECTED THE IDEA BEING ADVANCED BY THE IRS NAMELY THAT THERE IS SUBSTANTIAL NON-COMPLIANCE ON THE PART OF TIPPED EMPLOYEES AND SPECIFICALLY, OUR MEMBERS.

AS MOST OF YOU KNOW, THE HOSPITALITY INDUSTRY IS HIGHLY LABOR INTENSIVE. THOSE PEOPLE EMPLOYED IN OUR INDUSTRY INCLUDING A MAJORITY OF OUR MEMBERS ARE FEMALES, MINORITIES, UNSKILLED, AND SEMI-SKILLED. AT A TIME WHEN THEY ARE BEING LAID OFF OR THEIR INCOME IS SUBSTANTIALLY REDUCED BECAUSE OF THE ECONOMIC CONDITIONS IN THE COUNTRY, THIS PROVISION ON CHARGE TIPS WOULD ONLY BRING MORE CHAOS TO THE MARKETPLACE AND TO THE WORKPLACE. AS A MATTER OF SUBSTANTIATION, WE WOULD LIKE TO PROCEED WITH A BRIEF REVIEW OF THE RECENT HISTORY OF THE CHARGE TIP PROVISION TO BRING A HISTORICAL PERSPECTIVE TO THIS MOST IMPORTANT HEARING.

IN 1965, CONGRESS THOROUGHLY EXAMINED THE REPORTING REQUIREMENTS AND METHOD OF TAXING INCOME FROM TIPS RECEIVED BY EMPLOYEES. IN RECOGNITION OF LONG STANDING PRACTICES CONCERNING TIPS, AND IN RECOGNITION OF THE FACT THAT TIPS ARE AN EXTREMELY UNIQUE TYPE OF INCOME, CONGRESS ENACTED VERY PRACTICAL LEGISLATION, SPECIFICALLY REQUIRING THAT AN EMPLOYEE RECEIVING TIPS MUST REPORT THEM IN WRITING TO HIS EMPLOYER MONTHLY. THE EMPLOYER WAS THEN REQUIRED TO WITHHOLD INCOME AND SOCIAL SECURITY TAXES FROM THOSE REPORTED TIPS (SEC. 6053, INTERNAL REVENUE CODE). EMPLOYERS WERE ALSO REQUIRED TO RETAIN RECORDS OF CHARGE ACCOUNT TIPS AND COPIES OF THE TIP REPORTING STATEMENTS FILED BY EMPLOYEES.

CONGRESS ALSO RECOGNIZED THE COMMON, INDEED PREVALENT, PRACTICE OF TIP SPLITTING AND TIP POOLING, AND DETERMINED THAT, IN ALL FAIRNESS, ONLY <u>NET</u> TIPS RECEIVED BY AN EMPLOYEE IN HIS OWN BEHALF WOULD CONSTITUTE WAGES OR INCOME TO THAT EMPLOYEE. ANY PORTION

OF A TIP WHICH AN EMPLOYEE SPLITS OR GIVES TO A TIP POOL IS INCOME TO THE ULTIMATE RECIPIENT. AS A RESULT OF THIS DETERMINATION, SECTION 6051 OF THE CODE WAS AMENDED IN 1965 TO PROVIDE THAT AN EMPLOYER'S REPORT OF TIP INCOME ON FORM W-2 "SHALL INCLUDE ONLY" THAT TIP INCOME REPORTED BY THE EMPLOYEE TO HIS EMPLOYER. IT IS APPARENT FROM THE LEGISLATIVE HISTORY THAT CONGRESS WAS FULLY AWARE OF THE PRACTICES AND CUSTOMS OF TIPPED EMPLOYEES, AND WAS DEEPLY CONCERNED THAT EMPLOYER'S REPORTING AND RECORDKEEPING REQUIREMENTS BE MINIMAL. THIS SYSTEM HAS BEEN IN EFFECT FOR APPROXIMATELY 15 YEARS, AND THERE HAS BEEN NO SUBSTANTIATED SHOWING OF ABUSE OR PROBLEMS UNDER IT.

IN DECEMBER OF 1975, THE INTERNAL REVENUE SERVICE ISSUED REVENUE RULING 75-400 WHICH UNILATERALLY, AND WITHOUT PRIOR NOTICE OR CONSULTATION, ALTERED THE ENTIRE APPROACH OF RECORDKEEPING AND REPORTING. THIS RULING REQUIRED EMPLOYERS TO KEEP INDEPENDENT RECORDS OF THE AMOUNT OF CHARGED TIPS FOR EACH EMPLOYEE AND TO REFLECT THE TOTAL AMOUNT ON THE FORM W-2, WHETHER OR NOT THIS SAME AMOUNT HAD BEEN REPORTED BY THE EMPLOYEE. THIS RULING CHANGED THE RULES IN THE MIDDLE OF THE GAME, AND MADE THE EMPLOYER THE WATCHDOG AND COMPLIANCE AGENT OF THE IRS. THIS RULING WAS CLEARLY INCONSISTENT WITH THE LAW AND CONGRESSIONAL INTENT. IT OVERLOOKED THE WELL-KNOWN FACT THAT EMPLOYEES RECEIVING TIPS OFTEN SHARE THE TIPS WITH OTHER EMPLOYEES, AND THAT TO TAX THE EMPLOYEE ON THE FULL AMOUNT OF CHARGED TIPS ALLOCATED TO HIM WOULD BE MANIFESTLY UNFAIR.

IT IMPOSED A NEW AND EXTENSIVE RECORDKEEPING AND REPORTING BURDEN ON EMPLOYERS; UNJUSTIFIABLY IMPUGNING THE HONESTY OF MANY THOUSANDS OF TIPPED EMPLOYEES; AND CREATED A SOURCE OF CONFLICT BETWEEN EMPLOYER AND EMPLOYEE.

IN JUNE OF 1976, WHILE CONGRESS WAS CONSIDERING AMENDMENTS TO THE INTERNAL REVENUE CODE WHICH WOULD REVOKE REVNUE RULING 75-400 AND CLARIFY THE LEGISLATIVE INTENT OF THE PRIOR LAWS, THE IRS ISSUED ANOTHER RULING, REVENUE RULING 76-231. THE ISSUANCE OF THIS RULING WAS AN ATTEMPT OF THE IRS TO CLAIRFY THEIR OWN INTENT, YET ONLY COMPLICATED FURTHER THE REQUIREMENTS FOR COMPLIANCE. IT DID NOT MEET THE OBJECTIONS VOICED WITH RESPECT TO THE EARLY RULING AND ACTUALLY INCREASED THE BURDENS ON BOTH THE EMPLOYER AND EMPLOYEE.

SPECIFICALLY, IT CREATED NEW ADDITIONAL COMPLICATED REPORTING REQUIREMENTS <u>FOR WAITERS</u>; CONTINUED TO REQUIRE EMPLOYERS TO REPORT ALL TIPS ON A GROSS BASIS, INCLUDING "UNREPORTED CHARGED TIPS"; AND CREATED NEW COMPLICATED REPORTING REQUIREMENTS <u>FOR EMPLOYERS</u>. THE RESULT WOULD HAVE BEEN THAT EMPLOYEES WOULD REPORT ON A NET BASIS, THE EMPLOYER WOULD REPORT ON A GROSS BASIS, AND A RECONCILIATION WOULD HAVE BEEN REQUIRED SOMEWHERE ALONG THE LINE. AN ADMINISTRATIVE NIGHTMARE WOULD HAVE BEEN CREATED. FURTHERMORE, IT WOULD HAVE SUBJECTED EMPLOYEES TO TAXES ON WAGES THEY NEVER RECEIVED, I.E., POOLED TIPS, UNLESS THEY AFFIRMATIVELY FILED A STATEMENT WITH THE IRS EXPLAINING THE CIRCUMSTANCES.

I MUST EMPHASIZE AT THIS POINT THAT THE PRACTICE OF TIP SPLITTING AND TIP POOLING IS SO GENERAL IN GRATUITY OCCUPATIONS THAT IT HAS BEEN RECOGNIZED BY CONGRESS SINCE 1965 AND TAKEN INTO ACCOUNT IN OTHER LEGISLATION AS WELL, SPECIFICALLY THE FAIR LABOR STANDARDS ACT. IN THAT LEGISLATION CONGRESS ALSO DECLARED AN INTENT NOT TO INTERFERE WITH THAT TIME HONORED PRACTICE. IN 1976, THE SENATE PASSED A CLARIFYING AMENDMENT, SPECIFYING THAT THE ONLY TIPS WHICH AN EMPLOYER MUST REPORT WERE THOSE REPORTED TO HIM BY THE EMPLOYEE UNDER THE PRESENT LAWS. IT WOULD HAVE REVOKED REV. RUL. 76-231. SINCE THE CONTROVERSY AROSE AFTER THE HOUSE HAD CONSIDERED THE TAX REFORM BILL, THERE WAS NO COMPARABLE MEASURE IN THE HOUSE VERSION WHEN IT WENT TO CONFERENCE.

THE CONFERENCE COMMITTEE WAS VERY CONCERNED ABOUT THE PROBLEMS POSED BY THE NEW REVENUE RULINGS, BUT WAS UNABLE TO DISCERN FINAL RESOLUTION WITHOUT ADDITIONAL STUDY. ACCORDINGLY, THE CONFERENCE COMMITTEE DECIDED TO LEGISLATE A TWO-YEAR MORATORIUM ON THE NEW RULINGS, STATING THAT THE IRS WOULD NOT MAKE ANY CHANGES IN THE EXISTING TIP REPORTING REQUIREMENTS (THROUGH IMPLEMENTATION OF REV. RUL. 76-231 OR OTHERWISE) BEFORE JANUARY 1, 1979. THIS TWO-YEAR PERIOD WAS SET IN ORDER THAT THE CONGRESS HAVE AN OPPORTUNITY TO LOOK CLOSELY AT THE PROBLEM AND TO WORK OUT WHAT LEGISLATIVE CHANGES, IF ANY, ARE NECESSARY IN THE TIP INCOME REPORTING REQUIREMENTS.

IRS ARGUES THAT THERE IS SUBSTANTIAL NON-COMPLIANCE. YET IT OFFERS NO SUPPORT FOR THIS ALLEGATION. FURTHERMORE, IN THE PAST TWO YEARS, IT HAS NOT PROVIDED ANY RATIONALE OR DATA TO SUPPORT ITS PROPOSALS.

ONE FINAL POINT IS IN ORDER. WHENEVER THE IRS TALKS ABOUT CHANGING THE RULES FOR TIPPED EMPLOYEES, IT USES AS AN EXAMPLE A WAITER AT A FINE, HIGH PRICED RESTAURANT WHO WHEN COMBINING HIS SALARY AND TIPS IS EARNING A REASONABLY DECENT LIVING. IT IS HIGH TIME THAT THE IRS RECOGNIZED THAT THE SMALL HANDFUL OF GRATUITY EMPLOYEES SO SITUATED, UNFORTUNATELY, IS A MINISCULE PERCENTAGE OF THE FOOD SERVICE EMPLOYEES IN THE UNITED STATES.

WITH THIS IN MIND WE MUST RESPECTFULLY STATE OUR STRONG OPPOSITION TO ANY CHANGES IN THE CHARGE TIPS PROVISION. I URGE THIS COMMITTEE TO ONCE AGAIN REAFFIRM THE POSITION REACHED BY PREVIOUS CONGRESSES THAT INDICATED A REAFFIRMATION AND RE-ENFORCEMENT OF THE ORIGINAL INTENT OF THE LAW PASSED IN 1965. SIMPLE EQUITY AND JUSTICE STILL SUPPORTS SUCH A DECISION.

WE THANK-YOU FOR THE OPPORTUNITY TO APPEAR BEFORE THIS COMMITTEE, AND WOULD BE DELIGHTED TO ANSWER ANY QUESTIONS THAT YOU MIGHT HAVE.

94-522 O—82——20

Senator GRASSLEY. Senator Dole.

Senator DOLE. Well, again I have a number of questions. Maybe I will just ask a couple, and if it is all right with the witnesses submit the questions in writing.

Senator DOLE. I know it's a difficult problem. I was here in 1978 and before when we tried to deal with this question. But let's face it, when the compliance, at least the estimated compliance, is less than 20 percent, which I might say is down at the bottom of the heap with drug traffickers and others I won't mention, there has got to be some way to do something about it. I don't think the rest of the American taxpayers ought to make any class exempt from paying taxes because it is complicated. Paying taxes is complicated. A lot of people figure out complicated ways to avoid paying taxes.

What we need is some help from the three witnesses, not to tell us how complicated it is. Nobody wants to pay taxes, but neither does anybody want their taxes increased so that one group can continue not to pay taxes. And that's what we are up against this year. It's a different year. We're looking for revenues to lower deficits, to lower interest rates so more people will be out eating in restaurants and leaving tips—bigger tips. Now they hardly have enough to pay for the meal, as you have all indicated.

One way we are going to get economic recovery is to make certain that everybody has a chance to contribute—even the rich, and even those who haven't contributed.

Now, we get all kinds of horror stories on the other side that in some areas a good waiter's job—you have to pay $10,000 to get it in a posh restaurant. He's got to pay the employer to get the job. So there's big money in this business, and we've got a problem. You've got to help us address it. We're not after the working man and working woman. They'd work harder if the economy was better. Do you think we should use the Kennedy approach?

Mr. JULIANO. Do you mean the six martini?

Senator DOLE. No, it's three.

Mr. JULIANO. I thought it was six because of the inflation.

Senator DOLE. Well, inflation has dropped. It's down to a two-martini lunch now. [Laughter]

Mr. JULIANO. Mr. Chairman, I think you are somewhat familiar, we've lobbied a few tax bills. I think the more proposals that you confront the general public with, the greater problems you bring upon yourself.

As an example—and I'm not being facetious—we would strongly support this bill and find ourselves in a position of vigorously opposing it because of the provision that we consider to be unjust in specifically singling out our members for what we consider to be not fair treatment under the law. You know, we've talked to others in the Senate and in the House about revenue areas, and there are some that I think you will consider down the road such as repealing the third-year tax cut. We would like to do whatever we could to work with people as a way of broadly raising revenue and, I think, minimizing the amount of outcry that you would see from the public.

Senator DOLE. But why should we take away a third year tax cut from the taxpayers if we don't have to impose any tax on your group, or less than 20 percent? We are talking about $10 billion in tip income that's not reported. Ten billion dollars is a lot of money. We are talking about $2.3 billion in lost revenues. We are not talking about nickels and dimes. And I don't want to take away somebody's tax cut just so your group doesn't have to pay taxes. I know they are probably paid lower wages because of it by the restaurants and hotels, and that shouldn't be the case, either. But you have to give us a tip, how we are going to get out of this.

Mr. JULIANO. Well, the Senate and the House directed the IRS the last time, you said, "Sit down and work with these people." All right, we are now in a situation again where the first we hear of a proposal was, of course, when it is moving forward. They had two years since the last Congress. I don't know about the other two gentlemen—I'm sure they would have told me——

Senator DOLE. Do you have a proposal?

Mr. JULIANO. I would be happy to sit down and talk to them.

Senator DOLE. Could I get it by next week? Two weeks?

Mr. JULIANO. If the IRS wants to sit down and talk to us, sure.

Senator Dole. No, I'm serious. I think you should talk with us—Mr. Neville, Mr. Benefield and youself, or any representatives of the three groups. We are not out after any person, we are just trying to be fair. We are going to have testimony a bit later from people who think we are doing the right thing.

Mr. JULIANO. I'm sure you have a lot of proponents.

Senator DOLE. They also represent organized labor and others.

Mr. JULIANO. Yes.

I question whether the figures they have given you about the amount of revenue are correct.

Senator DOLE. I understand there are staff discussions underway now with your staff and IRS and our staffs. So maybe we are making some progress.

Mr. JULIANO. I discussed this last week with your staff, and we agreed to disagree.

Mr. NEVILLE. We had the same experience, Senator.

Senator DOLE. Well, we may lose, but we are going to try it. You ought to try to help us pick up a billion or two.

Mr. JULIANO. I would be happy to work with you in anyway.

Since we have done this twice, and in the past, Senator, with your support, and I know that the situation has changed, I don't want to——

Senator DOLE. Well, what is your view of Mr. Nolan's approach, I have given some thought to—but not a lot—to the rule that you couldn't claim a tip as a deduction unless you obtain a receipt? If I went somewhere to eat, or whatever, I couldn't claim a deduction for that tip unless I provided the necessary information. Maybe we can do it that way. It would be a more onerous burden on the taxpayer than it would be on the receiver of the tip, but you wouldn't object to that because that burden doesn't fall on your people.

Mr. JULIANO. Well, there has been an illusion, and I'm sure it's not intentional on your part, that my people don't pay taxes at all. Obviously they do. You are concerned about an area of noncompliance. That varies. The last time we testified before you it was 13 percent, so obviously the Service feels there is a dramatic increase in noncompliance.

I would say that the burden is on the taxpayer, and what we have said consistently is: there's the loss since 1965. My people reported on the back of their time card to the employer, the employer accepts that deduction, makes the appropriate deductions for withholding, and if the IRS has any questions about auditing they call in the individual members for that kind of an audit.

If a waiter kept slips and ended up with 15,000 slips in a year and was called in for an audit, he's not going to be able to prove where a lot of the people are anyway because of the turnover in the industry. And so the IRS is going to turn around and disallow it anyway.

Senator DOLE. I think we just have to put one more little sheet of paper in the credit card invoice. When you give them your credit card and they bring you back a piece of paper, the restaurant would be required to bring back two pieces of paper. One would be for the IRS, and I could send it in with my tax return.

Mr. NEVILLE. Well, Senator, I don't think that would solve your problem, though. You are still confronted with the tip pooling and tip splitting where you would attribute this money as income to that particular employee from whom you got the receipt; but it's not. Under the law it is not, until he decides what he is going to do with it—how much he is going to keep for himself, how much he is going to give to the busboy——

Senator DOLE. But you can't frustrate the whole tax compliance system because some taxpayers engage in tip splitting.

Mr. NEVILLE. Well, he is in a different situation from an employer.

Mr. JULIANO. There is also a separate area apart from your jurisdiction which has a large impact on us, and that's the illegal alien, undocumented alien problem which has an enormous impact on our industry and obviously in your area.

Senator DOLE. If it's all right I may like to submit some questions in writing.

Mr. JULIANO. Sure.

Mr. NEVILLE. We would be happy to answer any questions.

Mr. BENEFIELD. Sure.

Senator GRASSLEY. Do most restaurants retain the charge slips that their customers sign?

Mr. BENEFIELD. They are required to by law.

Senator GRASSLEY. How much would it cost you to implement the information reporting system that we have in our bill? Have you made any estimates of that?

Mr. BENEFIELD. I think in my operation it would probably require an additional employee 40 hours a week. I have a small hotel, but I have a fairly large ~~food business. We~~ do something over $2 million in food. And our one person who works in the office is fully utilized, so in our case I think it would require one additional person.

Another thing that bothers me is that I, like you, would like all the people to pay all the tax that's due, and I would like to get rid of the deficit. But in this provision I think only about 17 percent of restaurant meals—and Bob would probably know better than I—I think it is a relatively small percent that is charged in the form of credit cards. So that addresses a fairly small portion of the problem.

Senator GRASSLEY. You can answer that, too, if you want to, Mr. Neville. In conjunction with it, could you tell me whether or not it is less expensive for you to implement an information reporting system like we suggest in this legislation as opposed to a withholding system.

Mr. BENEFIELD. Well, the information would probably lead to a withholding system. But the information system, I think, would require about the same amount of work.

Mr. NEVILLE. Of course, you recognize that there would have to be additional changes in the statutes in order to do this because of the provisions of 6051 restricting the withholding to those amounts on tip income that the employee reports to the employer.

In our association, for example, about 80 percent of the members are individual entrepreneurs, and I think there is a general assumption that they all have elaborate accounting systems and data processing machinery and so on that would make this kind of information reporting not costly at all. But we don't believe that to be true. We feel that in most restaurants that we have talked to and polled, where they don't have the elaborate electronic systems, that is the data processing systems that some of the larger companies do have, as Mr. Benefield says, most of them tell me they would have to put on an extra bookkeeper to handle this particular problem by itself if that were the case.

I might suggest, too, if you are going to insist on the report on a 1099, that the problems for the employee really become magnified, unless a copy of that 1099 is provided to the employee. Because on the W-2 he at least sees what is being attributed to him as income. And he can go to the boss and say, "My God, Joe, you know darn well that I didn't hold that $5,000 that you say I got this past year. You know I gave some of it to Mary and some of it to John," and some to here and some there. And of course the employer knows this. The possibilities for friction between employer and employee are really tremendous in this area.

Senator GRASSLEY. Would you like to speak to that, Mr. Juliano?

Mr. JULIANO. Yes.

We have had numerous concerns expressed by our people about the concern of the workplace. In effect you would be asking the employer to assume an added burden and create more friction at a time when, with the overall economy being as soft as it is, we are very concerned that we have lost people, people are unemployed, and any further slippage would only enhance the possibility of additional problems between employers and employees.

The other thing, Mr. Chairman, is both you and Senator Dole have mentioned about the thrust of your bill going at higher income people, which we would again concur and want to work with you on. I would be pleased if I could get some figures from the IRS about where they classify our people; because if they are in the upper income brackets, I am going to go back and recommend that we raise our per capita and our dues for our members. Because the last time we checked they are low to middle, and in some cases upper middle. And if the IRS would like to bring in people that are paying $10,000 for a job, I'd be happy to bring up people who would be willing to testify before you that they over declare the amount of gratuities they get, particularly older people, so that the employer will deduct more for FICA so that they can build up a higher social security base since our people were never covered under Fair Labor Standards since 1966.

Senator DOLE. I might just say that they are losing a little less than a 20-percent rate, for estimating purposes. So that's not high income.

Senator GRASSLEY. One last question.

What percentage of your total sales are credit card sales?

Mr. BENEFIELD. In my particular operation about 30 percent.

Senator GRASSLEY. Yours, Mr. Neville?

Mr. NEVILLE. I can't tell you that, Mr. Chairman. I'll try to find out, though.

Mr. BENEFIELD. It is growing, I would say, over the years.

Senator GRASSLEY. I would appreciate that from you, Mr. Neville.

Mr. NEVILLE. All right, sir.

[The information follows:]

Sales in the commercial sector of the food service industry totaled approximately $105.6 billion in 1981. Based on industry research, we estimate that charge sales amounted to about 12 billion, representing nearly 12-percent of the commercial market.

Senator DOLE. Now, if in fact the bill is passed in its present or even modified condition, it's not effective until January, which will be long after the recession is over. [Laughter]

Senator DOLE. January of next year, that is.

Mr. NEVILLE. Could we put a trigger in that? We supported the third-year tax cut with a trigger, Mr. Chairman. If you could apply the same thing, we'd be happy to do it.

Senator DOLE. Well, if the recession doesn't end by January you won't need a trigger. [Laughter.]

Senator GRASSLEY. Thank you all for your testimony, and Senator Dole and I look forward to listening to any of the suggestions you have on this legislation.

Thank you very much.

Mr. BENEFIELD. Thank you, sir.

Mr. NEVILLE. Thank you.

Mr. JULIANO. Thank you.

Senator GRASSLEY. Our next witness is Mr. James Rowen, the Senior Partner of a Wall Street law firm. Mr. Rowen is the author of "The First Defense of a Penalty." The *Tax Journal,* 1976, published by Journal of the American Bar Association tax section.

## STATEMENT OF JAMES R. ROWEN, ESQ., ATTORNEY, PARTNER IN THE FIRM OF SHERMAN & STERLING, NEW YORK, N.Y.

Mr. ROWEN. I am an attorney in New York, a partner in the firm of Sherman & Sterling.

I will just summarize my statement briefly.

As a consequence of omissions of income, an aggressive position is taken on tax returns. The Government now does not receive the revenue that it should receive. There is an inequitable sharing of the tax burden among taxpayers. And, most important, there is a growing disrespect for the fairness of the tax system.

In my view the most practical and immediate way of improving compliance would be to reduce the odds that favor the taxpayer in the audit lottery. I believe that proposed section 6660 which would impose penalties for substantial deficiencies attributable to items not fully disclosed in the return would result in substantial improvement in tax compliance.

[The prepared statement follows:]

James R. Rowen
153 East 53rd Street
New York, New York 10022

March 22, 1982

Senator Robert Dole and
Senator Charles Grassley
Senate Finance Committee
2221 New Senate Office Building
Washington, D.C. 20510

Re: Sections 6622 and 6660 of Senate Bill 2198
"Taxpayer Compliance Improvement Act of 1982"

Gentlemen:

In recent years there has been a tendency for corporate and individual taxpayers to take positions on tax returns for which there is only a "reasonable" basis, even where the taxpayer or his adviser believes that the government probably would prevail if the issue were litigated. Under current professional standards this may properly be done, even without disclosure of the questionable item. (See Opinion 314 of the American Bar Association's Committee on Professional Ethics, 51 A.B.A.J. 671 (1965)).

In addition, reports in the press indicate that a substantial amount of dividends, interest, and capital gains is not reported. In cases where the Service discovers the omission it is often impossible or impractical for the Service to collect penalties under present law.

As a consequence of aggressive positions, as well as omissions, the government does not receive the revenue that it should receive, there is an inequitable sharing of the tax burden among taxpayers, and, most important, there is growing disrespect for the fairness of the tax system.

The problem is not easy to correct. It would help if the tax laws were simpler, but in trying to satisfy conflicting public interests the Congress has consistently made the laws more complex. It would also help if the Internal Revenue Service could enforce the laws more effectively, but in view of the complexities, the multitude of returns, the difficulty of establishing facts, and budgetary limitations, one cannot reasonably expect the Service to improve enforcement substantially. (For a fuller discussion of the problems see Committee on Tax Policy, Tax Section, New York Bar Association, A report on complexity and the income tax, 27 Tax Law Review 325, 330 (1972)).

In my view, the most practical immediate way of improving compliance would be to reduce the odds that favor the taxpayer in the "audit lottery". If a taxpayer will incur a material detriment where there is a substantial deficiency attributable to an undisclosed item there would be improved compliance.

The recent imposition of realistic interest rates on tax deficiencies has been helpful. However, many taxpayers figure that they will still be ahead moneywise if they take an aggressive position and have to pay only simple interest on any deficiency. Proposed section 6622, which provides for the compounding of interest, should remove the remaining "cost of money" benefit that results from deferral of tax payments.

However, many taxpayers consider that the big advantage of taking an aggressive position is that the return may not be audited, or the point may not be discovered on audit, or it may be possible to compromise the point when it is raised.

Proposed section 6660, which would impose penalties for substantial deficiencies attributable to items not fully disclosed in the return, should result in substantial improvement in tax compliance. I believe that enactment of penalties along these lines would benefit the tax system.

It might be better if the penalty (like the present penalty for underpayment of estimated tax) were figured in "interest" terms, i.e. a penalty equal to interest (at a certain rate) on the "underpayment". A single 10% addition to tax would not be as effective as, say, an additional 6% per annum "interest-type" penalty that continues until the deficiency is paid.

Sincerely,

James R Rowen

Senator GRASSLEY. Obviously that is a short statement.

Senator DOLE. Well, he's a good lawyer; that's why.

Senator GRASSLEY. I have some questions I want to ask you.

You know, your published article was very useful to Senator Dole and me and to our staffs. You are widely credited for suggesting a substantial understatement of tax penalty and interest compounding.

Do you think that the $5,000 figure for a substantial understatement of tax liability is a good number, or is it too large?

Mr. ROWEN. I don't think it's too low. I think a $5,000 understatement means a $10,000 omission or $10,000 excessive deduction. And when you combine that with what has to be 10 percent of the tax shown on the return, I don't think that's too low an item.

Senator GRASSLEY. Will this cause a significant reduction in the so-called audit lottery?

Mr. ROWEN. I think it will be helpful. I think, if people know there is going to be a penalty and they are forced to disclose the position they take in order to avoid the penalty, there will be much greater disclosure.

Going back to the point about the size of the penalty, maybe in the very high taxpayers 10 percent of the tax liability is too high an amount. Maybe you would want to say that if the omission of tax was, as I say, $1 million or $500,000, irrespective of the percentage, and there were no disclosure on the return, maybe the penalty should be assessed.

Senator GRASSLEY. All right. If we were to reject the penalty for substantial underpayment of tax, what other options would you say might be available to address the problem of the audit lottery?

Mr. ROWEN. You could ask for greater Service enforcement. I really don't think that that is practicable considering the complexity of the tax system: Multitude of returns and the difficulty of uncovering facts.

I think it would be great if Congress could simplify the tax law, but when I started, when the dinosaurs roamed the Earth, the Tax Code was maybe a quarter of an inch thick and now it's about 3 inches thick. I see no movement toward simplification. When you have to solve the conflicting pressures you have, you don't end up generally with simple solutions—you have complex ones.

Senator GRASSLEY. We have written 2,198 to have the underpayment penalty apply to corporations and individuals alike. Do you think it ought to apply to corporations?

Mr. ROWEN. I don't see why not. I don't think, particularly in the larger corporate taxpayers, that there is what you would call a deliberate omission of income. I think there are positions taken which are aggressive positions, taken on a reasonable basis, and I think there is no reason why these positions shouldn't be disclosed.

Senator DOLE. I know you have been waiting all morning. I appreciate your patience and your assistance.

Mr. ROWEN. Thank you.

Senator GRASSLEY. Thank you very much.

Our last witness is Robert S. McIntyre, director of Federal tax policy, Citizens for Tax Justice.

Mr. McIntyre.

Senator DOLE. Could I just say a word, because I have a departing staff member who wanted me to come to his luncheon.

I have read your statement, and I appreciate your willingness to assist us in what you call tax justice. I know different people view this in different ways, but that is how it is intended—not to overreach. Maybe if we have done that, maybe we should back off. I think, frankly, maybe we haven't gone far enough in some areas.

But I have read the statement, and I appreciate it very much.

Mr. MCINTYRE. Thank you, Senator.

Senator GRASSLEY. Go ahead, sir.

## STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, D.C.

Mr. MCINTYRE. Mr. Chairman, I am here representing Citizens for Tax Justice which is a coalition of public interest, citizen, and labor organizations which themselves represent tens of millions of American taxpayers.

We are very happy to be here to support your bill to improve taxpayer compliance. We think that's an important goal for the Congress to try to pursue. We've obviously got a serious problem here, and we think your bill goes a long way toward making that problem smaller.

We hope, however, that your thinking on this subject has not ruled out withholding, because we feel that ultimately, in some of the areas your bill covers, withholding is going to have to be the answer.

We have had a fair amount of experience with information reporting over the years, and we've been doing it better—the IRS has been doing it better—as time goes by. But we still run into problems that are intractible, I believe, unless we move toward withholding.

Now for the remainder of my statement, which is short, I just want to say something about the efforts that Senator Dole and Senator Domenici and others are making in terms of what I think may be the most important compliance problem in taxes today, and that is in trying to improve the fairness of the tax system by closing unwarranted loopholes and unwarranted tax subsidies which not only hurt compliance but hurt the economy because they make the free market not work very well.

We believe that these kinds of steps could do more to improve taxpayer compliance, as well as improve the economy and lower the deficit, than the maximum amount of increased enforcement.

As I talk to taxpayers around the country, I find many people who tell me that they are not paying their fair share, that they are cheating on their taxes. And more often than not the reason they cite is that other people aren't paying their fair share either. They look at the examples that make it into the press, the stories about Occidental Petroleum or General Electric or high-income people who show up in the high-earner reports as paying very little. And they say, "Why should I pay my share when other people aren't either?"

So, Senator, we really believe that the direction we have to move in is toward designing a system which is simpler and fairer.

I am told that at one of the Catholic churches last Saturday night there was a sermon about immorality in the economy as it currently stands. And the example that was cited was General Electric.

Well, we can argue about whether General Electric is moral or immoral, but the point is when we have a tax system that lets people making enormous amounts of money either pay nothing or get refunds from the Government, we have a system where compliance and taxpayer morale are in great danger.

So we hope that this year, now that we have cut the tax rates, we can look forward toward improving the economy and improving compliance by making the system fairer.

Thank you.

[The prepared statement follows:]

Citizens for Tax Justice
2020 K Street NW • Suite 200 • Washington, DC 20006 • (202) 293-5340



Summary of Statement of ROBERT S. McINTYRE,
Director, Federal Tax Policy, CITIZENS FOR TAX JUSTICE,
on S. 2198, THE TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1982
before the Subcommittee on Oversight of the Internal
Revenue Service of the Senate Committee on Finance
March 22, 1982

Citizens for Tax Justice is a coalition of public interest, citizen, and labor organizations dedicated to the improvement of the fairness and efficiency of our nation's tax laws, at the federal, state, and local levels. The groups included in our coalition represent the interests of tens of millions of American taxpayers. The following is a summary of our position on S. 2198, The Taxpayer Compliance Improvement Act of 1982:

1. We commend Senators Dole, Grassley, Chafee, Domenici, Danforth, and Stafford for introducing the Taxpayer Compliance Improvement Act of 1982. Enactment of this bill would not only make a significant contribution to narrowing the deficit,but would do so without imposing any additional burden on the overwhelming majority of working taxpayers, who currently pay their taxes honestly each year.

2. We also want to offer our strong support for the efforts of Senator Dole, Senator Domenici, and other members of Congress, who are working to try to improve the underlying fairness of our tax system by closing unwarranted loopholes and curbing abuses. If enacted, changes such as these would do far more than raise revenues. They would also improve the nation's productivity growth and our prospects for economic recovery by curbing tax-based economic distortions and wasteful tax shelter activity and by helping reduce ruinous interest rates. Moreover, by helping assure that our wealthiest and most powerful individual and corporate taxpayers bear some share of the tax burden, these proposals would do even more to enhance taxpayer morale and compliance than would increased IRS enforcement. As Business Week notes in its March 22, 1982 issue:

> "The government must rely for its taxes, in the end, on a general agreement among the majority of citizens that the tax system is equitable -- that is, that tax rates are reasonable and taxes are levied and collected fairly. It is not at all clear that such agreement exists today."

We welcome the opportunity to work with the Finance Committee in shaping equity and productivity enhancement tax proposals. We are hopeful that this year Congress can achieve a deficit-reducing package which also makes significant improvement in tax fairness and in the long-term economic growth prospects of our economy.

3. We should note that we do not view The Taxpayer Compliance Improvement Act as a substitute for extending tax withholding. Withholding on wages is the cornerstone of our pay-as-you-go voluntary compliance system. Years of experience with information reporting have taught us that, although a very useful tool, information reporting is no substitute for withholding at source. We urge the Subcommittee and the Congress not to turn away from withholding options as it considers means to improve taxpayer compliance.

Senator GRASSLEY. Senator Dole and I have been criticized by some for going after the little guy in our compliance bill. Obviously your organization is concerned with tax proposals that bear unfairly on low-income taxpayers.

Do you think that the corporate officers' fraud penalty provision of our bill, the tax shelter and audit lottery, the fraud penalty and capital gains reporting provisions, or any other provisions of the bill for that matter, are going after the little guy?

Mr. MCINTYRE. No, sir. Your bill goes after a combination of income groups, generally higher income groups, but across the spectrum. But none of those people that your bill goes after are the people that we represent, because we represent honest working taxpayers. And we support the intent of all the provisions in your bill.

Senator GRASSLEY. You properly state that wage earners pay their fair share of taxes. Some of our witnesses this morning have taken the view that we must resign ourselves to less than 20-percent compliance rate for tips. Do you believe that is fair to the wage earners?

Mr. MCINTYRE. No, sir. We do not. I think that that's an area that is seriously in need of correction, and I hope that the restaurant workers and the hotel owners can work with you to find something that they can live with, because we need to do something in that area or other working people are going to find the system unfair, and they are going to find their ways to get around it. And that's not good for any of us.

Senator GRASSLEY. In your testimony you quote a recent editorial that urges us to restore a sense of fairness to the tax laws before seeking better compliance. That editorial expressly suggests that rates are too high. The capital gains compliance rate is 56 percent, the long-term capital gains tax rate is 20-percent.

How low would that 20-percent rate have to go before we would secure greater compliance for the capital gains law?

Mr. MCINTYRE. Well, Senator, I didn't read that editorial to suggest that you should ignore enforcement. What the editorial said was that if we don't have a fairer system, enforcement efforts may not pay off as highly as we would like. And I agree with that. I think we should be moving on both fronts at once. The idea that capital gains rates are too high, I think is a joke. Our capital gains rates are very, very low. That's not our problem in compliance in that area.

Senator GRASSLEY. I have no further questions, but I might suggest to you that there may be other members of the committee who weren't here who would have questions to submit to you in writing. And we would appreciate your responding to those.

Senator DOLE. The record will stay open for a few days. So if there is anybody else who had written testimony that they wanted to submit for the record, that will be received.

I thank all the participants, all the members of the audience who were patient, and staff for making this a very productive hearing.

Hearing adjourned.

[Whereupon, at 1:33 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE TO THE SENATE FINANCE SUBCOMMITTEE ON OVERSIGHT RELATING TO THE COMPLIANCE GAP

April 9, 1982

The purpose of this statement is to present the views of the American Council of Life Insurance on the Taxpayer Compliance Improvement Act of 1982 (S. 2198), particularly the provision dealing with withholding on annuity payments. The American Council of Life Insurance is the major trade association of the life insurance business with a membership of 524 life insurance companies which, in the aggregate, have approximately 97% of the life insurance in force in the United States and hold 99% of the assets of all United States life insurance companies. Our member companies also had approximately 6 million annuities in force at the end of 1980.

Summary

We oppose the imposition of a mandatory withholding requirement on a wage withholding basis on insurance companies which make annuity payments. We believe implementing such a withholding procedure will result in considerable administrative burdens and costs to the insurance companies, and consequently a lower annuity payment to policyholders. Moreover, it will be extremely difficult for our member companies to determine the taxable amount of an annuity payment made under a contributory qualified plan and to administer a yearly election procedure. We believe that enactment of the provisions in S. 2198 dealing with improved information reporting, together with the existing voluntary withholding system, is a much more desirable way to deal with any compliance gap that may exist in the reporting of annuity payments.

## Specific Comments

### Mandatory Withholding on Annuity Payments on a Wage Withholding Basis

Section 131 of S. 2198 adds a new section to the Internal Revenue Code which would treat annuity payments as if they were a payment of wages by an employer to an employee. Unless an individual elects, on an annual basis, not to have any amount withheld from his annuity payments, insurance companies would be required to withhold under the general wage withholding rules.

Practical Problems. In the case of annuity payments received by a retired employee under a pension plan which is partially financed by his contributions, only the amount of the benefit that is attributable to his employer's contribution would be taxable. In order for the insurance company to withhold the proper amount, it would be necessary to know both the employer and employee contribution. Under most contributory pension plans, it would be impossible for an insurance company to determine these amounts since its records will not show a breakdown between employer and employee contributions. Usually, an employer sends one check for the total amount of the premium for the benefit. The distribution of cost between employer and employee is of no significance to the insurance company. And, there is no authority for insurance companies to compel an employer to furnish such a breakdown.

Delay in Annuity Payments. Before an insurance company would be able to withhold on an annuity payment, it would have to obtain a signed withholding exemption certificate (W-4) from the annuitant showing his marital status, the number of exemptions he claims and the other information required by the Form. Obtaining this information could result in a delay in payment since the insurance company could not begin the payments until the annuitant completed and returned the W-4 Form.

Administrative Burdens and Costs. Requiring insurance companies to withhold on annuity payments under the general wage withholding scheme would necessitate the installation of new withholding programs based on all the variables which are included for payroll withholding. For example, the program would have to include factors for marital status, number of exemptions, withholding tables and extra exemptions for itemized deductions. Such installation would be a very expensive and time-consuming process. We do not believe that the advantages of withholding on a wage withholding basis justifies the added costs and procedures that will be imposed on insurance companies which inevitably will be translated into lower annuity payments.

In addition, the election procedure set forth in proposed new section 3405(b) of the Code will result in insurance companies having to process massive amounts of paper in order to establish that withholding is not required. This result would be clearly contrary to the Reagan Administration's attempt to reduce the regulatory and paperwork burdens on business.

Moreover, as a practical matter, individuals in many cases either will fail to file the required form because of inadvertence or forgetfulness or will not file the form in time for the insurance company to process it before making payment. In addition, insurers will have to develop a system to receive and process the forms electing out of the system that will be filed with them each year. The confusion and misunderstanding this procedure will generate is substantial. Thus, we recommend that if there is mandatory withholding, there be no "election out" procedure. However, if an exemption procedure is provided, we recommend that an individual be allowed to elect out of the withholding system once, rather than on a yearly basis.

An Alternative Solution

We recognize that there may be a noncompliance problem regarding annuity payments. However, we believe that mandatory withholding on a wage withholding basis is too comprehensive, unnecessarily burdensome and complex and expensive. Therefore, we recommend that section 131 of S. 2198 not be enacted.

We believe that a more appropriate alternative is to strengthen the information reporting system. In particular, we strongly support section 104 of S. 2198 which would amend section 6011 of the Code to allow the IRS to require large payers to file information returns on magnetic tape. In this regard, we are pleased to note that many of our larger members are already filing the required information regarding annuity and other payments with the IRS on magnetic tape. Our understanding is that the ability of the IRS to match information received on magnetic tape with individual returns has greatly increased. In addition, payers are now required to furnish a copy of the information return to the payee. In our view, these factors, taken together, should greatly reduce any noncompliance gap that may exist in the reporting of annuity payments.

Withholding of a Mandatory Fixed Percentage and Exemption for Small Payments

If mandatory withholding is going to be required for annuity payments, we believe a much more desirable approach than general wage withholding is withholding of a flat percentage of the amount of the annuity payment. Withholding at a flat rate will remove the practical problems and considerably ease the administrative burdens and costs to insurors which would be involved in implementing withholding on a general wage withholding basis. And, if the flat percentage is set at the appropriate rate, it should not result in any excess withholding for annuity recipients.

As part of this suggested alternative, we also recommend that there be an exemption from withholding for small amounts. Most annuitants are elderly people living on fixed incomes from pensions and Social Security who most likely pay little or no federal income taxes because of low income and large exemptions. Thus, any withholding would be particularly burdensome on this group of people. In addition, it does not seem appropriate or necessary to require this group to elect out of any withholding system that may be imposed, even if the election is a one-time election. Thus, we urge that if there is mandatory withholding on annuity payments, the statute provide for an exemption for annuity payments of $500 a month or less.

Effective Date

We urge that if any change is made to the withholding rules regarding annuity payments, insurers be given a sufficient amount of lead time to comply. Developing new computer programs or modifying existing programs to accommodate changes in the law is very time-consuming and costly. The more time that is available to make the necessary changes, the more orderly and less costly those changes will be. Therefore, we strongly urge that insurers be given an adequate amount of time to comply with any new requirements imposed on them.

Commercial Annuity

Proposed new section 3405(g)(4) of the Code defines a commercial annuity as including an insurance contract. We urge that insurance contracts be removed from the definition since in most instances payments under such contracts are not taxable and therefore would not be subject to withholding. To require insurance companies to determine what small portion, if any, of the proceeds from a life insurance contract is taxable, would result in unnecessary burdens and expenses.

The income tax treatment of life insurance death proceeds is governed by section 101 of the Code. Generally, gross income does not include amounts received, whether in a lump-sum or otherwise, under a life insurance contract, if such amounts are paid by reason of the death of the insured. In addition, amounts received under a life insurance contract during the life of the insured are not taxable until the policyholder has received amounts equal to his investment in the contract. In most instances, therefore, amounts received under life insurance contracts would not be taxable and would not be subject to mandatory withholding.

We appreciate having the opportunity to present our views on S. 2198. We would be happy to attempt to answer any questions the Subcommittee may have.

AICPA

American Institute of Certified Public Accountants
1620 Eye Street, N. W., Washington, D. C. 20006 (202) 872-8190

April 12, 1982

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
2227 Dirksen Senate Office Building
Washington, DC 20510

Re: S. 2198 - Taxpayer Compliance Improvement Act of 1982

Dear Mr. Lighthizer:

The AICPA respectfully requests that the enclosed comments on S. 2198, the "Taxpayer Compliance Improvement Act of 1982" be entered into the record. The hearing was held on March 22, 1982 before the Senate Finance Committee's Oversight of the IRS Subcommittee.

Thank you for this opportunity to comment on the bill.

Sincerely,

Kenneth F. Thomas

Kenneth F. Thomas
Director
Federal Tax Division

Enclosure

General Comments

The Taxpayer Compliance Improvement Act of 1982, S. 2198, is intended to reduce noncompliance with federal tax law through a series of provisions designed to encourage complete and accurate reporting of income and deductions. We generally concur with the desired objectives and agree with the concept of most provisions of the bill. The following comments on specific provisions of the bill concern those that we either object to or we believe require further study.

Section 102—State and Local Income Tax Refunds.

The bill would require information returns for state and local tax refunds of $10 or more be filed with the IRS and taxpayers.

We support the concept of this provision. However, consideration should be given to increasing the level of refunds requiring reporting from $10 to $100. This increased limit would reduce the paperwork burden on state governments and the IRS without obviating the purpose of this section.

Section 113(a)—Interest with Respect to Delinquent Returns.

Under the bill, no interest will be paid on overpayments shown on late returns for any day before the date on which the return is filed.

We object to this provision. Enactment of this provision would codify a severe inequity against taxpayers. Except for the 45-day rule of Code Section 6611(e), we believe that the date from which interest runs should be the same date whether the late return entitles the taxpayer to a refund or results in an additional tax liability.

Section 113(c)—No Interest on Refunds Caused by Certain Carrybacks Until Claims Filed by Taxpayer.

Under the bill, no interest will be paid on overpayments resulting from a net operating loss carryback or credit carryback prior to the date a claim is filed for such overpayment.

We object to this provision. Enactment of this provision would also codify a severe inequity against taxpayers. Again, except for the 45-day rule of Code Section 6611(e), we believe that the date from which interest runs should be the same date whether an adjustment to a prior taxable year entitles the taxpayer to a refund or results in an additional tax liability. If abuses are perceived to exist in this area, the changes proposed in section 112 of the bill should eliminate those problems.

Section 113(d)—Effective Dates.

We object to the effective date for the amendments made by Section 113(c If Section 113(c) is enacted, it should be effective for tentative carryi adjustments filed after the 30th day after the date of enactment in lieu payments of interest made after the date of enactment with respect to in accruing after March 11, 1982. The provisions should apply only prospec so that taxpayers will receive a reasonable period of time to comply wit an adverse effect.

Section 121—Fraud Penalty on Corporate Directors, Officers, Employees, and Ag

The bill will impose a new civil fraud penalty on corporate directors, of employees, or agents who knowingly participate in fraud that results in a underpayment of tax by the corporation. Such individuals will be jointly severally liable for a penalty equal to 50 percent of the part of the cor underpayment due to fraud, but the amount that can be collected from any individual will not exceed $100,000.

We agree with the concept of this provision; however, we object to the me achieving the desired result. The use of such a large dollar amount as t maximum amount that can be collected from any one individual is clearly a case of legislative overkill and does not reflect the liable person's abi to pay. Further study is necessary in determining the appropriate penalt also believe that this provision should clearly differentiate corporate a from tax return preparers, since penalty provisions already exist for tax preparers. Section 6694 assesses income tax preparers with a civil penal certain negligent or willful attempts to understate a taxpayer's liabilit Section 7206 provides for criminal penalties. Section 121 also does not the potential doubling up of penalties in the closely-held corporation wh officer is also a shareholder and, thus, impacted by corporate-level pena

Section 124(a)—Minimum Penalty for Failure to File Information Returns.

The bill increases the penalty for failure to file certain information re from $5 to $50 per failure with a yearly maximum of $50,000. A minimum p will be imposed if the failures are due to intentional disregard of the f requirements.

We agree with the concept of this provision but believe further study is necessary to determine the appropriate penalty.

Section 124(b)—Increase in Civil Penalty on Failure to Supply Identifying Num

The bill increases the penalty from $5 to $50 per failure to a maximum of $50,000 per year, for a person who fails to: (1) include his TIN in a re (2) furnish his TIN to another person, or (3) include, in any return or s made with respect to another person, the TIN of such other person. If a of type (3) is intentionally made, the penalty is $100 per failure with m

We agree with the concept of this provision but believe further study is necessary to determine the appropriate penalty.

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Section 124(c)—Withholding of Tax in Certain Cases.

The bill provides for withholding at the source at a tax rate of 15 percent i a taxpayer fails to supply a TIN or supplies an incorrect TIN to another pers who must file a return with respect to payments to the taxpayer. Withholding would generally continue as long as the taxpayer failed to supply or correct his TIN.

We agree that withholding encourages compliance. However, we believe that further study should be made of the appropriate rate of withholding. Use of a 15 percent withholding rate may well encourage an unacceptable degree of nor compliance by taxpayers whose marginal tax rates exceed 15 percent.

We also feel that withholding at the source should be required only if a taxpayer fails to supply a TIN to another person who must file a return with respect to payments to the taxpayer. It seems unlikely, if not impossible, for a person to realize that the taxpayer has supplied an incorrect TIN.

Section 125—Penalty for Substantial Understatement.

The bill will add to the Code a new penalty for substantial underpayment of tax arising from items not disclosed on the taxpayer's return. The penalty will be 10 percent of that part of any underpayment of tax arising from an undisclosed item. An underpayment of tax will be substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 for individuals, or $10,000 for corporations. The penalty may apply in addition to the negligence penalty but not the fraud penalty. An item will be considered disclosed only if information in the return, or an attachment to the return, is adequate to apprise the Secretary of the nature and amount of the item.

We agree that a taxpayer should not be allowed to play the audit lottery by taking unsupportable positions that would be disallowed if discovered on audit but which are so artfully concealed that they are not apt to be discovered. We object to this particular approach because it will have the exact opposite effect on this perceived problem.

Requiring disclosure will, we believe, only cause taxpayers with supportable positions to consider disclosures of assertive positions on their return, increase the cost of tax return preparation, and exceed the IRS's ability to audit the detail being provided. While the additional disclosure might increa the intellectual quality of tax controversies, it will not increase tax revenu Enactment of the provisions as drafted would encourage taxpayers who have take unsupportable positions in the past to continue to conceal those positions and rely on the audit lottery to avoid discovery. They would be even less likely to be audited as the IRS struggled to audit the tax returns with disclosure. In addition, existing provisions that impose market interest rates on assessed deficiencies should already discourage much of the perceived abuse.

When the preparer penalty provisions were enacted in The Tax Reform Act of 197 it was intended that such penalty apply generally to every negligent or intent disregard of the federal tax laws, rulings and regulations, except that a good faith dispute by an income tax preparer about the interpretation of a statute

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(expressed in regulations or rulings) was not to be considered a negligent or intentional disregard of rulings and regulations. By enacting Section 125 of this bill, we believe that the Congress would sharply limit the taxpayer's right to such a good faith dispute about the interpretation of a statute, regulation, or ruling.

In addition, the provision upsets the long-standing relationship between the IRS, the practitioner and the taxpayer. Due diligence in preparing a return would require a conscientious preparer to identify to the taxpayer any situation to which section 125 would apply. A conscientious practitioner would thus be placed in a position where he might be perceived by his or her client as an advocate of the IRS and an adversary of the taxpayer. A premium will be placed on uninformed and less conscientious practitioners.

The implications of this provision are too important and far-reaching to enact into law in haste. It is imperative, that further study and consideration be given to the instances in which abuses exist and to effective approaches of discouraging those abuses.

ANSON AVERY
CERTIFIED PUBLIC ACCOUNTANT
2810 EAST 29TH, SUITE 207 • SPOKANE, WASHINGTON 99203 • (509) 534-7010

April 3, 1982

Robert E. Lighthizer, Chief Counsel
Committee of Finance, Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Senate Bill 2198

Dear Subcommittee Members,

I am a practicing CPA, and most of my work is concerned with Federal income tax matters. Like many citizens I am concerned with the growing tax protest movement and the I.R.S, response to it. It is good that you are considering ways to collect more delinquent taxes but I question one aspect of the current bill.

Commerce Clearing House, Inc. reports that Senate Bill 2198 may include a new penalty of 10% for items on tax returns that differ with published I.R.S. positions regarding those items.

Many new penalties have been added since the landmark legislation of 1976 yet the delinquent tax amounts have increased since 1976. We do not need more penalties. We need more I.R.S. manpower.

I represent two taxpayers who owe back taxes for 1978, 1979 and 1980. We met in my office last week to prepare an offer to the I.R.S. for payment of those taxes. I telephoned the local I.R.S. collection office and talked to Mr. (Name furnished upon request) about scheduling a meeting to submit financial information and a payment plan.

The collection agent did not want to schedule the case "at this time", seems that he has a workload of 250 cases. I insisted on a meeting to resolve the case since the taxpayers were ready and willing to make substantial payments and they were anxious to be in good standings with the service.

Later I was contacted by another collection agent who said that he was already assigned the case and that he could help us except that he had heard that the taxpayers were moving to Nevada and "...Why not let them contact the local I.R.S. office there?"

I answered that the move might not occur and that the taxpayers wanted to pay now so we should keep the appointment on April 9, 1982. He agreed to the meeting only after I strongly insisted on keeping the schedule because I am heavily involved in tax work and a change would be difficult for me and the taxpayers.

This letter is not to complain about the two overworked collection agents. They are doing their best, but how can any one person handle 250 of the toughest cases that I.R.S. has?

Senators -- do not add unenforcable, unfair and resented penalties. It does not work. Instead authorize more agents to enforce the laws that are already on the books.

Yours truly,

Anson Avery

Anson Avery, CPA

AA/ec
CC: Richard R. Orosco, Acting District Director, Seattle, WA

Statement by California League of Savings and Loan Associations

with respect to

S.2198 - Taxpayer Compliance Improvement Act of 1982

on which a hearing was held March 22, 1982

As accountants for the California League of Savings and Loan Associations, Peat, Marwick, Mitchell & Co. urges the Subcommittee on Oversight to provide the League additional time to present its views regarding the material adverse effects S.2198 will have on member associations. The League would specifically like to address the provisions of S.2198 that would change existing rules on interest payable on tax refunds due to net operating loss carrybacks. The proposal to deny the accrual of interest on such refunds until Forms 1120 and 1139 are filed will force affected taxpayers to greatly accelerate the filing of such forms, causing significant strains on manpower at a time when annual financial statements for calendar 1981 are still in process of completion. It will also lead to accelerated requests for payments of refunds by the Federal Government which will only exacerbate the Government's present budget situation on a cash basis. Finally, we believe that the proposal raises serious questions of equity in that it would further distort existing interest payment rules which already favor the Government over individual taxpayers.

Savings and loan associations across the country, perhaps more so than any other industry group, have experienced significant net operating losses in 1981 and will be affected adversely by S.2198. The California League respectfully requests an opportunity to have its views considered and believes other associations and their trade organizations will welcome a similar opportunity.

Thank you for the opportunity to present our views on this most important matter.

CITIBANK

Citibank, N.A.
399 Park Avenue
New York, NY
10043

John F. Rolph, III
Vice President-
Tax Legislation

April 12, 1982

The Honorable Robert J. Dole
Chairman, Committee on Finance
United States Senate
Washington, D. C. 20510

Re: S.2198, the Taxpayer Compliance Improvement Act of 1982

Dear Senator Dole:

Citibank takes this opportunity to submit the attached written comments on S.2198, the Taxpayer Compliance Improvement Act of 1982, which you introduced on March 11, 1982. Although a hearing was held on March 22 before the Subcommittee on Oversight of the Internal Revenue Service, due to apparent inadvertence Citibank and other interested parties did not receive advance notice of this hearing. Therefore, we were not in the position to provide oral comments at the hearing on March 22.

Citibank strongly supports full compliance by taxpayers with the income reporting requirements of the Internal Revenue Code. Therefore, the objectives of S.2198 are meritorious.

However, the purpose of the attached written comments is to suggest that appropriate attention should be given to a number of problems which are raised by S.2198 in its present form. These problems are briefly summarized as follows:

1. Information reporting on bearer and other debt obligations.

The extension of current IRS reporting requirements to debt obligations covered under S.2198 would have an extremely adverse impact on the liquidity of the capital markets, and the continuing ability of businesses to borrow through the issuance of short-term debt obligations. If the proposal is enacted in its present form, it would require a year of lead time for corporate payors, banks, and brokers and securities dealers to develop and implement EDP (as well as manual) systems --- if this in fact can be done --- to comply with these reporting requirements. It would be impossible to report interest and other payments on debt obligations made in the 1981 taxable year, as is presently required by the bill. The bill, as currently drafted, leaves many important questions unanswered which would result in unintentional non-compliance in many situations.

2. Withholding on pensions, annuities and deferred compensation plans.

The requirement of mandatory withholding on lump sum or total distributions, and automatic withholding on periodic payments, would create serious problems for retirees and others who have little or no Federal tax liability. The bill does not provide for exemption certificates or relief in the countless cases where overwithholding will occur.

3. Increased penalties for failure to file information returns.

Although the objectives of these penalty provisions are fully understandable, many payors would incur substantial penalties due to failure to comply with the new information reporting requirements on bearer instruments and other debt obligations under S.2198 because of the ambiguities in the information reporting provisions as presently drafted.

Citibank offers its services in working with the Members and the Committee Staffs to develop a fuller understanding of the problems which exist under S.2198. It is respectfully suggested that there are possible methods of solving the problem of more adequate reporting of financial information to the Internal Revenue Service as an alternative to the reporting requirements which are imposed by S.2198.

Yours very truly,

Ted Rolph

John F. Rolph, III
Suite 350
1200 New Hampshire Avenue, N. W.
Washington, D. C. 20036
202-293-4855

Attachment

CITIBANK, N.A.

S.2198 (H.R. 5829) - TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1982

SUMMARY OF COMMENTS

INFORMATION REPORTING ON BEARER DEBT OBLIGATIONS - The bill would require full information reporting to the IRS of payments of interest, etc., on corporate debt obligations issued in bearer form, e.g., commercial paper, money market CD's, bankers acceptances, corporate bonds and U.S. governmental obligations, e.g., Treasury bills, notes, bonds, and other Federal agency issues. Payments of interest, etc., to individuals and entities (other than corporations) would be required to be reported.

Impact on financial markets - Information reporting on corporate bearer and U.S. Government debt obligations would have a highly adverse impact on the liquidity of the financial markets. The (1) data capture, (2) computation of interest, discount, OID and capital gain, and (3) record retention would cause serious slowdowns in the transfers of debt obligations, and would reduce the liquidity of these debt instruments.

Due to the current volatility in interest rates, corporations borrow heavily through short-term bearer issues such as commercial paper. At the end of 1981, the dollar volume of short-term bearer debt obligations had increased to $423 billion, more than double the $196 billion at the end of 1977. Information reporting would seriously reduce the efficiency of the financial markets and would lessen the ability of businesses to borrow in these markets.

Cost of information reporting - Information reporting on debt obli-[illegible]ions would involve costly and time consuming changes in EDP and [illegible] records systems. The substantial costs for corporate issuers, [illegible] brokers, and dealers, would be passed on to the public in the [illegible] higher interest costs and increased fees and charges. At [illegible]one year of lead-time would be necessary to change EDP and [illegible]ystems to comply with information reporting. The bill [illegible]etroactively to interest and other payments on obligations [illegible] taxable year 1982. There is no way that interest payors [illegible]lly comply with this requirement.

[illegible]ns Unresolved

[illegible]ll leaves important questions unresolved, e.g., (i) who is [illegible]nsible for reporting interest payments, (ii) what specific [illegible]s of payments other than interest are required to be reported, (iii) what specific types of debt obligations are covered, etc. These questions should be answered by statute, rather than by IRS regulations or rulings.

INFORMATION REPORTING BY "BROKERS" - Brokers would be required to file information returns on profits and losses on all commodities and securities transactions with customers, and sales or transfers of corporate and U.S. governmental short-term obligations, e.g., commercial paper, bonds, notes, bills, etc.

The reporting requirements for brokers are ambiguous. Presumably, transactions by dealers (although not mentioned) would be covered. Brokers and dealers lack the information and the EDP or manual systems necessary to capture, compute and store the required data.

WITHHOLDING ON PENSIONS, ANNUITIES AND OTHER DEFERRED COMPENSATION - The bill would require mandatory withholding at-source on total or lump sum distributions on deferred compensation plans, pensions, annuities, etc. Automatic withholding would be required on interim or periodic payments for such plans. Taxpayers could file notice forms electing not to have tax withheld on periodic or interim payments.

Mandatory withholding on deferred compensation plans would require the filing of millions of exemption certificates or refund claims by retirees for amounts overwithheld. Retirees would be required to file millions of notice forms with pension plan administrators to avoid automatic withholding on periodic payments. The U.S. Government would receive revenue windfalls from persons failing to file exemption certificates, refund claims, and notices to not withhold.

INCREASED PENALTIES FOR FAILURE TO FILE INFORMATION RETURNS AND TID'S - The bill would substantially increase the penalties imposed on payors for failure to file information returns. Additionally, substantially increased penalties are provided for failures, unintended or intentional, to supply taxpayer identification numbers.

These increased penalty provisions would have unintentionally harsh results. Until the information reporting requirements on bearer instruments and U.S. Government obligations are clarified, and the compliance period is extended, there will be countless cases where payors will fail to file information returns. Increased penalties for failure to file ID numbers will fall particularly harshly on aged or disabled persons who don't understand the requirements and who owe little or no tax.

CITIBANK, N.A.

S.2198 (H.R. 5829) - TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1982

IRS Information Reporting on Corporate and U.S. Bearer Obligations (Sec. 101)

Senator Dole, Chairman of the Senate Finance Committee, on March 11, 1982, introduced S.2198 (H.R. 5829, introduced by Rep. Conable) entitled "Taxpayer Compliance Improvement Act of 1982". This bill would, inter alia, require full IRS information reporting of interest and other payments on all debt obligations issued by corporations in bearer form, and payments by the U.S. Treasury and Federal agencies on U.S. obligations. The bill would apply to payments made in 1982, to be reported on tax returns due to be filed on or before April 15, 1983.

Impact of Information Reporting on the Liquidity of Financial Markets

The single, most important negative effect of the requirement to file information returns on bearer obligations would be on the liquidity of the financial markets. Today, as in the past, the efficiency of the market in bearer and U.S. Government obligations, including secondary market obligations, depends upon liquidity, i.e., the speed with which transfers of these obligations can be effected in the financial markets.

A major factor in the transferrability of bearer and other similar debt obligations is the fact that minimal record keeping is necessary. The imposition of complex information reporting requirements on these obligations would significantly reduce their liquidity.

After analyzing the impact of a similar 1978 information reporting proposal, the Carter Administration concluded that the adverse economic impact on the financial markets and the costs to payors would outweigh the benefits that would accrue from revenue gains.

According to Federal Reserve data, the total volume of short-term debt obligations issued in 1977 such as bearer commercial paper, bankers acceptances, and money market CD's amounted to $196 billion. At the end of 1981, the dollar volume of these short-term bearer obligations had increased to $423 billion, more than double the 1977 figure. The volume of commercial paper had increased from $57.5 billion in 1977 to $101 billion in 1981. Treasury short and long-term debt had risen from $438.5 billion in 1977 to $670.5 billion in 1981

To avoid reducing the ability of businesses to obtain short-term financing, the liquidity of short-term debt must be maintained. Information reporting on short-term bearer obligations would directly impact the liquidity and efficiency of the capital markets, due to the enormous volume of record keeping that would be required.

Types of Debt Obligations and Payments Covered

Although Section 101 of the bill is lacking in specificity, it is assumed that the information reporting on debt obligations would apply, but would not be limited, to the following types of obligations, including debt obligations transferred in secondary markets, which are either issued in bearer form or are issued in registered form but are not currently subject to information reporting: (1) commercial paper, (2) money market certificates of deposit, (3) bankers acceptances, (4) debentures and capital notes, issued in bearer form, (5) bonds issued in bearer form, including coupon bonds, "zero" discount bonds (and bearer Euro-dollar bonds, if held by persons or entities for whom information reports must be filed), and (6) all U.S. governmental obligations issued in bearer form, or in registered form (but not currently subject to information reporting). Interest, and presumably discount, OID, and capital gains, would be required to be computed and reported.

Retroactive Application to Payments Made in 1982

The rules relating to interest on bearer obligations would apply to all returns filed after December 31, 1982. Hence, under this effective date provision, the new rules would apply retroactively to payments of interest, discount, OID (and gains and losses) required to be reported by taxpayers for the 1982 taxable year in quarterly and annual income tax returns due to be filed on or before April 15, 1983.

Complexity of the Proposal - Unresolved Questions as to Application

The proposal would require information reporting of payments of interest (and -- presumably -- discount, OID, and capital gain or loss on redemption) on money market debt obligations issued in bearer form and U.S. debt obligations issued in registered form. No such reporting is presently required. In amending Section 6049, the proposal would require reporting on payments of interest, etc., by "every person -- to any other person" during any calendar year. Although payments to publicly held corporations are presumably excluded under Section 6049, it is not clear whether --- in addition to individuals --- interest payments to private corporations, partnerships, joint ventures, estates and trusts are also to be covered by the bill.

As the nation's principal financial intermediaries, banks perform a variety of functions with respect to corporate and governmental securities, i.e., banks are (1) issuers of their own debt obligations, such as money market certificates of deposit and negotiable bankers acceptances, (2) issuing agents (i) for corporations which issue short and long-term debt, such as bearer commercial paper, bonds issued in bearer form and (ii) for the U.S. government in the case of U.S. Treasury and other governmental obligations issued in bearer and registered form, (3) paying agents for both corporations and the U.S. Treasury, with respect to corporate and governmental debt issues, (4) collection agents and custodians for debt issuing corporations and the U.S. Treasury, under which function banks hold funds to be disbursed and debt obligations for safekeeping and (5) dealers in governmental securities and money market debt obligations.

For example, if a bank is a paying agent -- in the case of corporate bonds, commercial paper, or U.S. Treasury obligations -- a bearer commercial note, a bearer Treasury obligation, or a bond or bond coupon will be presented for payment to the paying agent bank by the holder of the obligation or coupon. Such an obligation may have been negotiated by transfer to several prior holders before it is presented to the paying agent bank. The paying bank would have no way of knowing the parties involved in any such interim transfers or the consideration paid upon each prior negotiation. It is a common practice for several banks to be involved in the issue, transfer, and redemption of a single bearer instrument, i.e., the issuing agent bank, the bank to which presentment is made, the paying agent bank, and the custodial bank to which the bearer obligation is ultimately presented for collection. In this sense, bearer obligations are processed in the same manner as checks (particularly checks issued payable to bearer) and are subject to transfer and collection procedures which are analogous to check clearing.

Impact on EDP and Manual Records Systems

The bill would require the "tracking" of all holders (individuals, and presumably PC's, partnerships, and joint ventures) of bearer and other affected instruments which are traded daily in large volumes in the financial markets. It is deemed to be virtually impossible under existing EDP systems (1) to obtain the name, address, and taxpayer identification number of each of the several holders of negotiated bearer obligations, and (2) to compute the interest, discount, OID or capital gain or loss at redemption attributable to each such holder who held obligation and transferred it to a subsequent holder prior to redemtpion by the last holder at muturity.

With respect to transactions in corporate and governmental debt obligations (presumably including purchases and sales of bearer obligations in the secondary market) the legislation would require changes in existing automated and manual systems with respect to: (i) transaction identification, including the name, etc., of each holder, (ii) transaction recordation, (iii) mathematical computation to report simple or compounded interest, negative interest, interest accruals between specific dates or transfers, discount, OID, and capital gain or loss at redemption, (iv) retention of data in automated or manual systems, and (v) submission of data to the IRS on information returns or machine tapes, and to taxpayers on information returns.

Each existing EDP or manual records system in a financial institution is currently designed to handle the minimal data processing or record retention required by current financial market practice and regulation. In the case of EDP systems, the proposal would require extensive research and development in systems capabilities and the running of pilot programs to determine the capability to capture, generate and retain the newly required information. Thus, new systems would have to be carefully designed to comply with the requirements of S.2198. At least one year of lead time would be needed in order to put new data capture, computation and retention systems in place.

In many financial institutions, EDP systems are not centralized but are decentralized on a functional or operating center basis. Some banks maintain computers in their main offices which handle only main office operations (either centralized or decentralized) and maintain separate computers in individual branches which service branch operations. The nature of each computer system is determined by the EDP requirements of the particular operating function or area which the computer serves.

In the case of manual record keeping systems, existing personnel would have to be trained in new procedures, and additional personnel would have to be diverted to the record maintenance and data computation function. In many cases, new personnel would have to be hired to handle these functions.

Information Returns Required by "Brokers"

Section 101 of S.2198 establishes new information reporting requirements for commodities and securities "brokers". Because the term "brokers" is not defined in the bill, or in the Internal Revenue Code, these requirements may be construed to apply also to dealers in commodities and securities. Under the bill, "brokers" would be required to --

1. File information returns reporting "profits and losses" on all commodities and securities transactions with customers, pursuant to regulations to be issued under Section 6045.

2. File information returns on the sale or transfer before maturity of any bond or other debt obligation (other than one transferred by a corporation), or any Treasury bill with maturity of not more than one year or any corporate debt obligation (not registered with the SEC) with a maturity of not more than one year.

EDP and manual record retention systems currently employed by brokers and dealers in commodities and securities lack the capability to generate accurate information on profits and losses on commodities and securities transactions and sales or transfers on corporate and Treasury debt obligations. Frequently, a broker or dealer has information only on one end of the transaction, i.e., the purchase or the sale, but not both. In many situations firms lack the necessary data to calculate both profits and losses on securities transactions with customers. As in the former case, more than one firm may be involved in the transactions necessary to calculate profits and losses. It may be seriously questioned whether the IRS can use or "match" fragmented and incomplete data which would be reported on commodities and securities transactions.

Withholding on Pensions, Deferred Compensation Plans, Annuities, Etc. (Sec. 131)

Section 131 would impose withholding requirements on both lump sum distributions and periodic payments from pensions, deferred compensation plans, annuities, etc.

Mandatory Withholding on Total or Lump Sum Distributions

The bill would add new Section 3405 to the Internal Revenue Code which would impose mandatory withholding on qualified distributions which are total or lump sum distributions in the case of tax qualified retirement plans, pensions, deferred compensation plans, employee's trusts, annuities, IRA's, etc. Under current law, total or lump sum distributions under these plans are not subject to withholding. The bill also provides that payors of total or lump sum distributions would deduct, withhold, and be liable for payment of the tax subject to withholding.

Automatic Withholding on Periodic or Interim Payments

Periodic or interim payments to individuals under eligible retirement plans or commercial annuities would be subject to automatic withholding. Periodic or interim payments are treated for tax purposes as payments of wages by an employer to an employee. Payors and plan administrators may be liable for the payment of the tax which is subject to withholding.

Recipients of periodic payments may elect not to have the tax withheld. This election would be made by providing notice to the payor, under regulations to be promulgated by the IRS.

Under Section 131, there is no provision for the filing of exemption certificates. Individuals who either have no tax liability or have tax liability less than the amount of tax withheld would have to file exemption certificates or tax refund claims with the Internal Revenue Service to collect amounts overwithheld. Mandatory withholding will result in the generation of a huge volume of exemption certificates and refund claims.

A like volume of notice forms will be filed with payors containing elections not to withhold in cases of automatic withholding on periodic or interim payments. Many individuals who fail to file such notices, and who owe little or no tax will be entitled to file refund claims. The regulations would have to provide for periodic renewals of notices not to withhold on periodic payments because many taxpayers would be subject to changes in tax status.

The U.S. Treasury will receive a revenue windfall from countless individuals who are overwithheld and who fail to file exemption certificates, refund claims, and notices to payors not to withhold.

Increased Penalties for Failure to File Information Returns and TID's (Sec. 124)

The bill would increase the penalty for failure to file information returns from $10 to $50 per return, with the maximum liability being increased from $25,000 to $50,000. The penalty for "intentional disregard" of this filing requirement is 10% of the aggregate amount of items not reported (except that the penalty is limited to 5% in the case of brokers), with no maximum dollar limitation. Anyone who is required to supply a taxpayer identification number who fails to do so is fined $50 for each failure, with a maximum liability of $50,000. "Intentional" failure to file ID numbers results in a penalty of $100 per failure, with no maximum dollar limitation on the aggregate penalty. If an employer is required to withhold taxes on payments of wages, failure of an employee to provide a correct identification number requires the employer to withhold a tax equal to 15%.

Although the objectives of the increased penalties are meritorious, in practice they will probably have unintentionally harsh results. For example, until the information reporting requirements on bearer instruments and U.S. government obligations are clarified, and adequate time for their implementation is provided, there would be countless cases where payors will fail to file information returns either due to misunderstanding or inability to comply with the requirements. In the case of the increased penalties for failure to file ID numbers, these penalties will fall particularly harshly on aged or disabled persons who don't understand the requirements and who owe little or no tax.

April 12, 1982

Statement of

The ERISA Industry Committee (ERIC)

For the Record of the March 22, 1982, Hearings on the

"Taxpayer Compliance Improvement Act of 1982" (S. 2198)

By the

Subcommittee on Oversight of the Internal Revenue Service

Of the Committee on Finance

United States Senate

This statement deals only with withholding on deferred income and related reporting requirements and is submitted on behalf of The ERISA Industry Committee (ERIC), an organization of some one hundred major employers which maintain employee benefit plans for the benefit of their employees.

## SUMMARY OF POSITION

The growth of the income tax compliance gap is a serious national problem which affects all taxpayers. Accordingly, ERIC strongly supports properly balanced proposals to close the compliance gap.

ERIC supports the important proposals to improve the operation of information reporting systems and to enhance the Service's enforcement capability. These measures would increase taxpayer compliance without creating excessive new paperwork burdens. More specifically, ERIC supports the proposal to permit the Secretary to require reports on magnetic tape or in other machine processable form, but only if the plan administrator or employer already has the capacity to do so. ERIC would also support reasonable improvements in the content of existing reports from payors of deferred income, if adequate lead time for compliance were permitted.

ERIC opposes the proposed withholding on partial or total distributions from qualified plans because it would impose harsh burdens on the elderly and unnecessary and costly administrative burdens on employers and plan administrators.[1] More promising solutions for underreporting of deferred income are (1) education of retirees and soon-to-be retirees to the taxable nature of their distributions, to their present ability to

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[1] Employers' estimates of compliance costs depend upon such factors as the number of plans, the number of payees, employer size, the sophistication of present systems, and existing computer capabilities. Thus, preliminary and incomplete estimates vary greatly. The highest exceed $400,000 per employer for start-up costs and $100,000 per year thereafter.

elect withholding on annuity distributions, and to their obligation to file estimated returns and (2) improved use by the Service of the information submitted by payors.

Payors of retirement benefits are presently required to file information returns on Forms W-2P and on Forms 1099R. The compliance gap arises from the Service's inability to process the presently required information effectively, not from payors' failure to report. If retirees know that the Service will take action if they fail to pay estimated taxes, elect voluntary withholding, and/or report their distributions on their returns, compliance should improve. If the current reporting and enforcement system worked as intended, the compliance problem would be greatly diminished. Thus, ERIC joins with the bill's sponsors in urging funding of the Service's enforcement efforts at a more appropriate level.

The compliance problem with deferred income should be addressed in the same manner as that for dividends, interest, and capital gains, that is, through reports from payors to the Service and improvement of the Service's use of those reports, rather than by automatic withholding. There is no reason why retirees should bear a greater burden than recipients of dividends, interest, or capital gains, or why plan administrators should be put to any greater burden than other payors.[2J]

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[2J] Commissioner Egger's statement estimated that the unpaid tax on deferred income was $2.8 billion in 1981. This is less than one-third of the estimated unpaid tax on capital gain income and significantly less than the estimated unpaid tax on either dividends or interest. It is roughly the same as that on wages, on which there is mandatory withholding. It is less

(footnote continued)

## SUBJECT TO APPROPRIATE LIMITATIONS, ERIC GENERALLY SUPPORTS REQUIRING ADDITIONAL REPORTS TO THE SERVICE, PARTICIPANTS, AND BENEFICIARIES

The bill would provide specific regulatory authority to require the employer or plan administrator to make returns and reports to the Service, participants, beneficiaries, and other persons. The contents of such reports are not described in the bill, but Assistant Secretary Chapoton's testimony noted that the present information reporting system may not always result in participants and beneficiaries receiving all of the information necessary to determine the tax treatment of distributions and then indicated that "plan administrators would be required to provide both the recipients of distributions and the Internal Revenue Service with the information needed to determine income tax liability".

ERIC believes that, if recipients of retirement benefits understand that a portion of all of their distributions may be subject to tax, most will comply with the tax law. Either they will request withholding under present law at an appropriate level, taking into account their other income, deductions, and exemptions, or they will make estimated tax payments. Most of those who fail to report retirement income properly do so through a misunderstanding of the taxable nature of such dis-

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(footnote continued)

than five percent of the total unpaid tax on individual legal sector income for 1981. It is important to note, however, that these estimates are not estimates of the revenue which would be raised by the proposals in question. Such estimates have not been made available by the Treasury or Congressional staff.

tributions; relatively few may believe that the Service does not effectively enforce existing law. Thus, improvements in reporting may well obviate the need for automatic withholding.

Generally speaking, employers and plan administrators now provide information to employees and beneficiaries regarding the tax treatment of distributions, although there is no requirement either that they do so or that they report the information to the Service. If the content, form, and timing of the new reporting requirements are not overly burdensome, ERIC would generally support reporting to the Service and to employees and beneficiaries information which is routinely available to plan administrators and which is reasonably necessary for determining the tax treatment of any distribution.

In any event, ERIC urges that the Treasury's authority to prescribe regulations should be carefully circumscribed to avoid the overly burdensome reporting requirements which have been common in other areas involving qualified plans. Furthermore, particular care must be taken to assure adequate lead time for plan administrators and employers to revise existing information collection and reporting systems.

ERIC OPPOSES THE WITHHOLDING PROPOSALS

Withholding would be required for any partial distribution (principally annuity payments) from a qualified plan, unless the former employee elected not to have withholding apply. Regulations would prescribe the time and manner of making the election, but notice would have to be given to each former employee of his right to make an election, and notices and elections would be required annually. The amount withheld would be determined as if the taxable amount of the distribution were wages.

The bill would also require withholding on total distributions (generally referred to as "lump sum distributions") unless the former employee certified that he intended to "roll over" the distribution to an IRA in a tax-free transaction. Withholding tables would be published which would assume that the entire taxable amount of the distribution would be ordinary income which would qualify for special ten year averaging.

In the case of both annuity payments and lump sum distributions, the amount withheld could not exceed the sum of money and the fair market value of other property (excluding employer securities) received in the distribution. The proposal would be effective for distributions made after December 31, 1982.

These provisions would cause significant hardship for retirees, who are particularly ill-equipped to deal with them, would add significantly to the cost of administering plans, and could cause many plans, particularly defined contribution plans, to eliminate further periodic or annuity forms of distributions.

### A. An Annual Election Procedure Would Be Unduly Costly and Confusing to the Elderly

Under current law, recipients of annuity benefits may request withholding from the payor. No tables are prescribed, and the payee may request whatever level of withholding is appropriate to his individual circumstances. The essential difference between existing law and the proposal is to place upon retirees the annual burden to elect "out" of, rather than to allow them a continuing option to elect "in" to, the withholding system.

Assistant Secretary Chapoton's testimony expressed concern that the proposal may impose undue administrative burdens on plan administrators. ERIC submits that the proposals would place harsh and unnecessary burdens on both plan administrators and retirees. The requirement that recipients of periodic distributions make an affirmative election each year not to have withholding apply would yield a costly administrative nightmare. Retirees are widely scattered, and, accordingly, the printing and postage costs alone would be significant. In addition, significant time would be expended attempting to explain each year to retirees both the election procedure and its effects.

Notices of elections would be lost, mislayed, and, in many cases, never received or received too late to afford a response. For example, many pensions are paid directly to a bank or other financial institution for credit to the retiree's account, and the payor has no idea where the retiree may be located.

Most significantly, and too often, notices would be misunderstood by retirees. Many retirees are not sophisticated. Many are aged or infirm. They may be in nursing homes; they may be senile; they may be impaired in hearing or eyesight. Many of these retirees cannot be expected to understand or to make a rational response to an election notice. How does one explain to an elderly person that his or her retirement check will be reduced if the election form is not promptly and properly returned? Those who have made an election one year may well not understand that they must make a new election each succeeding year for the rest of their lives. Retirees with more than one pension would receive multiple notices, adding to their confusion. Similarly, there would be multiple notices with which to contend if both spouses received pensions. In sum, retirees would find dealing with the notices and elections to be confusing and unsettling.

ERISA requires that retirees be sent summary plan descriptions (SPDs) and summary annual reports (SARs). These requirements, though well intended, and these documents, though carefully drafted, are confusing and unsettling to many retirees. Whenever SPDs or SARs are provided, it is unfortunate, but inevitable, that the only reaction of significant numbers of retirees is "does this mean I will lose my pension?". It is likely that many retirees would find annual notices and elections even more confusing, unsettling, or fearsome.

Even for plan administrators with the best recordkeeping systems, election forms would not be returned and would be lost or misfiled when returned, and retirees would suffer. Unlike the current system under which a plan administrator often determines the amount of an annuity benefit once and the check is then automatically sent for as long as the retiree lives, the amount of the check may change from year to year, depending on whether the retiree returns an election form for each year.

Procedures and computer programs would have to be revised to take into account changes in the withholding tables applicable, from time to time, to wages. All retirees who did not elect annually that withholding not apply would be subject to the same withholding table, even though there are differences in other income and other factors which affect their ultimate tax liabilities. Would retirees to whom withholding applies have to file Forms W-4 or their equivalents? Without such forms, how would one distinguish between a retiree who is entitled to extra exemptions and one who is not? Processing of these forms would be expensive, and plan administrators are not presently handling them. Indeed, the cost of complying with an automatic withholding system with annual election and annual withholding exemption procedures in many cases would exceed the amount of tax withheld.

No annual notification is required for withholding from wages; an employee claims only once his exemption and extra or reduced allowances, and his directions are followed until changed. Similarly, under the current voluntary withholding system, an annuity recipient may elect withholding and the election is followed until modified. There is no reason why the present withholding system should be modified with respect to the effect of an election.

### B. Over Withholding and Interest-Free Loans to the Government Would Be Unfair to the Elderly

The proposals would result in frequent over withholding on lump sum distributions because a sizeable portion of many employees' distributions qualifies for capital gain treatment.

This proposal appears to be a convenience for the Service, not a substitute for estimated tax payments which would take into account the lower tax rate applicable to the capital gain portion of the distributions.

An employee would not be permitted to request withholding at a lesser amount, as is currently the case for annuity distributions, or to waive withholding. Thus, an employee who received a lump sum distribution during the year would have to wait until his tax return was filed after the end of the year to claim the refund to which he would be entitled. The result could be a compulsory interest-free loan to the Treasury.

Many of those who would receive election notices regarding their annuities have no tax liability, pay no estimated tax, and correctly file no income tax returns. Retirees frequently qualify for additional exemptions for the aged and/or the tax credit for the elderly. Failure to elect "out" of automatic withholding would require retirees to file claims for refunds. Many would not, thus creating an unfair windfall for the Treasury, and those who did obtain refunds would have made unfair interest-free loans to the government. Only a few very sophisticated retirees would have the ability and knowledge to adjust their estimated tax payments on other sources of income to avoid such interest-free loans to the Treasury.

The proposed withholding might well result in significant over withholding, and the major effect might be the elderly's deprivation of a portion of their pensions. This could have a significant adverse effect on the elderly who are not well-to-do.

### C. The Proposal Could Cause Elimination of Some Periodic Forms of Retirement Benefits

Enactment of the proposal could lead to the elimination by some employers of periodic forms of benefit payments. ERIC is concerned that ERISA's imposition of the joint and survivor annuity requirements on defined contribution plans resulted in many plans eliminating optional annuity forms of benefit payments in favor of lump sum or fixed term distributions. The administrative costs associated with automatic withholding and the election procedures could further discourage employers, particularly smaller employers, from offering optional periodic forms of distributions. If lump sum distributions became the predominant form of benefit, many employees and their beneficiaries would suffer since they would no longer be able to tailor distribution schedules to fit their individual circumstances or desires.

### D. All In Kind Distributions Should Be Exempt from Withholding

In the case of many individual account plans, the employee is allowed to direct his own investments in one or several investment media. Frequently, these plans provide for distributions in kind. Given adequate time and employee sophistication, the sales of investments to satisfy the required withholding might be arranged to meet an employee's desires. Such arrangements would, however, also increase administrative costs. If an employee made no designation, the plan administrator would have to decide which of the employee's investments to liquidate in order to have cash available to satisfy the required withholding.

The bill provides an exception for distributions of employer securities, which is very important especially in the case of ESOP or TRASOP plans which invest principally or solely in employer securities. A similar exception should be provided for all in kind distributions from individual account plans.

THE EFFECTIVE DATE FOR ANY NEW REQUIREMENTS SHOULD AFFORD ADEQUATE LEAD TIME FOR IMPLEMENTATION

Commissioner Egger noted the wide-ranging potential impact of the bill on the data processing systems of both the private sector and the Service and urged that adequate lead time be provided to implement any new requirements. The bill would require withholding on payments made after December 31, 1982. As a practical matter, neither plan administrators nor the Service would be able to comply with this requirement.

It is unlikely that any bill will be enacted before June 30 at the earliest. Once enacted, the Service would have to publish withholding tables; regulations would have to be issued regarding the election procedures; and decisions would have to be made regarding whether Forms W-4 are permitted or required. Under normal conditions, the Treasury must permit at least thirty days for comment by affected retirees and plan administrators, and a public hearing may be requested by any interested party. Thus, it would take at least three months (or until October 1) for the Treasury and the Service to provide all necessary regulations, procedures, and forms.[3]

Only then could employers and plan administrators begin the process of adopting procedures and modifying computer programs. Even for the most sophisticated, this could be expected to take at least three months (or until January 1, 1983). Once everything was in place, notices to retirees would be sent out, and responses would be processed when returned.

Assuming that a retiree would have at least sixty days from the time of mailing to respond to an election notice and that plan administrators would have at least another thirty days to implement retirees' elections (or failures to elect), the notification, election, and implementation procedures would take at least another three months. Thus, even assuming enactment by June 30 and the swiftest possible action and best efforts of the Treasury, the Service, and plan administrators, it is not reasonable to expect that any withholding could be accomplished before April 1, 1983, i.e., before at least nine months after enactment. Even these prospects may be unrealistic because they depend upon the Treasury and the Service issuing all necessary guidance within three months of enactment and all plan adminis-

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[3] The bill would require regulations to be issued "as soon as possible" after enactment. This provision was opposed as undesirable and unnecessary by both Assistant Secretary Chapoton and former Assistant Secretary Hickman. We agree with them that the Treasury currently pursues issuance of regulations diligently. Nonetheless, the factors which prompted the sponsors to propose such a rule, including the current regulations backlog, suggest that final regulations may not be issued within three months of enactment.

trators, large and small, being able to implement that guidance within six months.

Accordingly, ERIC suggests that, if, notwithstanding the arguments against the withholding proposals, they are adopted, it would be most appropriate to provide that no withholding be required until at least 180 days after the Treasury issues final regulations to implement the new requirements. Similarly, any enhanced reporting requirements should not be effective until at least 180 days after the Treasury issues final regulations.

Respectfully submitted,

Jerry L. Oppenheimer

and

Robert H. Swart

Mayer, Brown & Platt
888 17th Street, N.W.
Washington, D.C. 20006
(202) 785-4443

JLO/RHS/sa

STATEMENT OF
FOODSERVICE AND LODGING INSTITUTE
ON
BILL S. 2198
THE
"TAXPAYER COMPLIANCE IMPROVEMENT ACT"
BEFORE THE
SUBCOMMITTEE ON FINANCE
U.S. SENATE

March 29, 1982

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STATEMENT OF THE FOODSERVICE AND LODGING INSTITUTE

The Foodservice and Lodging Institute herewith submits its comments on provisions of the proposed "Taxpayer Compliance Improvement Act of 1982", which deal with reporting and withholding of charge account tips. We respectfully request that this statement be included in the record of these hearings.

The Institute, hereinafter referred to as FLI, is a trade industry group of thirty-six of the nation's largest multi-unit and multi-state restaurant and hotel companies which, collectively, employ in excess of 2.7 million persons. Approximately half of our members accept credit cards as payment for services and food in their establishments.

The proposed "Taxpayer Compliance Improvement Act" provision of concern to our members, as well as to the industry in general, would require employers to a report to the Internal Revenue Service tips that are added to a waiter's check by a charge account customer and then paid over to the waiter by the employer.

FLI objects to this proposal as unwarranted and unnecessary; it would place an enormous burden on restaurant employers; it would not provide the IRS with either meaningful or useful data; and, most importantly, it would shift the burden of certifying the accuracy of tip reporting from the employee to the employer.

In the 1978 Revenue Act, on this same issue, the Congress concluded, and rightly so, that "requiring employers to report to IRS charge account tips paid to employees on the basis of charge receipts would place unnecessary recordkeeping and reporting burdens on the employer and would fail to provide the IRS with precise information on the amount of tip income taxable to the particular employees." The Congress also concluded that in some cases, "the widespread practices of tip splitting and tip pooling would result in an employer's reporting to the IRS an amount of tip income that is greater than the tip income taxable to a particular employee."

It should be noted that the 1978 legislation was not based on an action by Congress or any of its members but rather a reaction to an Internal Revenue Service Revenue Ruling, enforcement of which was stayed by Congress in 1976, for at least until January 1, 1979, and then overruled in the 1978 Act.

Now, the issue is being dredged up again and Congress is again asked to reverse itself despite the fact that the end result will still be the same.

CONGRESS CORRECTLY CONSTRUED THAT REPORTING OF CHARGED TIPS WOULD BE AN ADMINISTRATIVE NIGHTMARE

Under current law, an employer is required to report to IRS tips which are actually reported to him by his employees, pursuant to Section 6053 of the Internal Revenue Code. Additionally, as a result of the 1978 Revenue Act, the employer must also keep charge receipts and copies of statements furnished by the employees.

Hence, the only requirements are minor recordkeeping ones which place little or no burden on the employer, particulary no burden which is not applied universally to all employers.

This would not be the case under the proposal now being considered. The employer would be forced to keep a new set of records; that of charged tips which the employer has turned over to he employees.

What would this extra recordkeeping mean to the IRS? Absolutely nothing!

In the restaurant and hotel business, this convoluted new reporting system as outlined above would be a worthless recordkeeping exercise because of the practice of tip splitting and/or tip pooling, a practice which is practically universal in our industry.

In a tip splitting arrangement, despite what may appear as a credit card tip for a particular employee, at least one other employee and frequently several employees will receive a percentage, including one or several busboys, a maitre-d', head waiter, wine steward and/or bartender. The amounts shared vary between individuals. There is no uniformity as to any particular tip splitting scheme within the industry. In fact, the practice of tip-splitting is seldom regulated by the employer in any way. Even though the employer may be able to identify and record the name of the employee who received the credit card tip, he generally has little or no knowledge of the extent to which that tip is finally divided and to whom.

Under a tip pooling scheme, these reporting requirements would be totally useless and completely misleading. In a pooling arrangement, a waiter or waitress places all or a portion of all tips, both cash and charged, into a common pool. At the end of the shift, the entire pot, converted to cash, is then divided up under a mutually agreed percentage to a number of the establishment's employees. Employees are quick to agree to a tip pooling arrangement because some stations in a restaurant are better tip producing than others and since the tables are routinely rotated among waiters and waitresses, each employee is still guaranteed an equitable tip income despite slow tables. Again, it is the employees themselves who participate and manage the pool. In such an arrangement the disparity between what the employer will record as the charged tip and what the employee actually receives from the pool will be immense.

WITHHOLDING FOR CLAIMED CHARGED TIPS WOULD BE IMPOSSIBLE

If the problems of reporting charged tips is a bad dream then the withholding on the basis of charged tips would be a nightmare. Consider these recordkeeping problems.

Generally, cash wages for an employee reporting over $5.00 per hour in tips would be insufficient to pay the withholding taxes due. The employer would be required either to collect additional cash from the employee to satisfy the withholding tax obligations, or to carry forward the employee's liability from week to week for a period of one year. To add to the confusion, the employer would be subjected to a difficult priority in claims for withholding taxes. Social Security and Federal income taxes due on wages exclusive of tips would have the first priority for purposes of withholding taxes. Social Security taxes due on reported tips would have the second priority. Third priority would be Federal income taxes due on reported tips. Fourth priority, presumably, would be state withholding taxes due. Finally, would be priorities such as union dues and other deductions.

CONCLUSION

While the purposes of this proposal may be admirable, the end result will be unfathomable. While the IRS may feel that all employees may not accurately report their monthly tip receipts to their employees, the IRS should not shift the investigative burden and the enforcement responsibilities to another entity. It is incorrect to assume that the employer has a duty to insure that the amount actually reported by the employee is true and accurate. What the IRS is attempting to do is have the employer insure that the amount actually reported is true and accurate, even when the employer knows that accuracy and truthfulness cannot be accomplished under provisions of this bill. The employer cannot be responsible for the accuracy or inaccuracy of these tip reports. The employer's purpose is to act as a "messenger" not as an "accuser".

The Internal Revenue Service presently has the means to investigate what they deem to be inaccurate filings. It should use them.

We respectfully urge that Congress once again determine the inequities of this proposal and strike it, as they have so many times in the past, from this bill. This time, we also hope that Congress will bury it for good.

94-522 O—82——24

STATEMENT OF DONALD C. LUBICK AND COLLETTE C. GOODMAN SUBCOMMITTEE ON OVERSIGHT, SENATE FINANCE COMMITTEE S. 2198, "THE TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1982" APRIL 12, 1982

Mr. Chairman and Members of the Subcommittee, we appreciate the opportunity to submit this statement in connection with the March 22 hearings on the Dole-Grassley compliance proposals. This statement reflects our personal views as private practitioners as well as former officials of the Treasury Department.

We strongly favor taking all reasonable steps to improve compliance and ensure the fairness of our tax system. At a time when taxes have been sharply cut, deficits are rising rapidly, and critical choices on spending have to be made, it is particularly important that every person pay his or her full share of taxes due under the law.

In recognition of this need, the Taxpayer Compliance Improvement Act of 1982 (S.2198) contains several proposals aimed at improving compliance. They may be differentiated in two classes. First, the bill seeks to ensure that reportable income not currently being disclosed on tax returns is in fact fully reported. Better compliance in reporting of income would be achieved mainly through a combination of expanded information reporting, increased penalties, and withholding of taxes on pension payments.

Second, the bill seeks to prevent taxpayers from claiming unjustifiable deductions that reduce the amount of reported income subject to tax. The bill seeks to deter taxpayers from gambling that they will not be called to account through a change in the riskiness of non-compliance. The bill would impose a new 10 percent penalty in cases of substantial understatements of tax liability.

Our comments which follow deal mainly with the broad policy considerations that we believe the Committee must address in fashioning its compliance initiatives. We believe that the bill is, generally speaking, a significant improving step forward in compliance, although expansion of withholding would in the case of dividends, interest and compensation to independent contractors be a far simpler, more equitable and more efficient way to deal with most of the problems addressed by this legislation in those areas of nonreporting of income.

In considering ways to improve compliance in the reporting of income, in our view there are four principal objectives that such proposals should help to further:

1. Fairness - The integrity of our income tax system depends upon all taxpayers paying their share of the tax burden. Nevertheless, a serious compliance gap exists today in the reporting of income. One of the most serious noncompliance problems that exists, and which we dealt with at length at Treasury, is the problem of so-called independent contractor workers who are not subject to withholding and do not pay their fair share of taxes because they fail to report the full amount of their compensation.

An IRS study conducted in 1978 found that the income tax noncompliance rate among these workers was as high as 46 percent and even higher in the reporting of income for social security tax purposes. Serious problems also exist in the reporting of other types of income, such as interest and dividends, capital gains and pension and annuity income. This noncompliance diminishes public respect for the operation of the tax system and jeopardizes our system of voluntary compliance. Moreover, such conduct is patently unfair to honest taxpayers who must, as a result, bear a larger share of the tax burden. And as a budget matter, non-reported income is a major source of additional revenue for the Government without any substantive law change.

2. Voluntariness - Any system of compliance measures must rely upon, and therefore should facilitate, self-assessment at the return stage. Given the relatively scarce resources of the Government to audit returns and collect unpaid taxes, the system must be designed to ensure the highest possible compliance in the absence of our ability to audit every taxpayer.

3. Efficiency - The administrative costs to both taxpayers and the Government should be minimized as much as possible. We believe it important to emphasize that a system that entails in the first instance lower private

sector costs but higher governmental costs ultimately involves greater overall costs for taxpayers, because the costs to the government ultimately must be borne by the taxpayers. Thus, the appropriate measure of efficiency is the overall administrative costs that any system will entail in order to achieve an acceptable level of compliance, so long as the burden on the private sector is not unreasonable.

4. Privacy - Finally, any system of compliance also must be designed in a manner that will minimize intrusions into the affairs of individual taxpayers. A system that is overly intrusive, or that has the appearance of being overly punitive, will undermine the public's perception of the tax system and willingness to comply with our tax laws.

In looking at specific proposals to improve compliance, in our view withholding clearly stands out as the best means of achieving the four objectives referred to above. Withholding affects all taxpayers equally, unlike a system of information reporting and penalties that depend upon whether or not the IRS "catches up" with the taxpayer. It also facilitates voluntary compliance by enabling taxpayers to pay taxes in a gradual, systematic way. By contrast, information reporting does not in any way facilitate for taxpayers the actual payment of taxes. For a family with only $15,000 in earnings, assuming four exemptions and use of the standard deduction (zero bracket amount), the tax liability for which they must budget in the absence of withholding is over $1,000. We doubt that any one today would recommend abandonment of our system of wage withholding. For the same reasons, in our view, compensation paid to workers who happen to be treated as independent contractors should be subject to withholding.

In this regard, we do not subscribe to a point of view that believes that the payment of taxes should not be facilitated too much because the "pain" of paying taxes will make people more conscious of the taxes they pay and more in favor of cutting back on government spending. If withholding is appropriate for United Way contributions - to facilitiate payment - there is no reason not to facilitate current payment of tax obligations. Making the payment of taxes "burdensome" only would undermine the tax system without having any rational impact on spending decisions.

If we are not to have withholding, however, second best measures to improve compliance must be considered. Turning to the specific proposals contained in S.2198, we would make the following comments.

Interest and dividend income: Under current law most payments of interest and dividends aggregating more than $10 in a calendar year are subject to information reporting. The two main categories of obligations not covered by existing reporting requirements are obligations of the U.S. Government and corporate bearer obligations. S. 2198 would eliminate this gap by extending information reporting to both of these categories of obligations. Apart from compliance concerns, it is only fair that the U.S. Government bear the same reporting responsibilities with respect to its own obligations as it imposes on private issuers. In addition, the issuance of interest bearing obligations in bearer form creates an opportunity for individuals to evade tax since there is no record of ownership maintained by the issuer. Thus, we believe that this proposal for extending information reporting is both a reasonable and much needed compliance measure.

Interest Rate Adjustments. We believe that the recent increase in the interest rate on deficiencies to 20 percent has had a salutary effect and we agree with those provisions of S. 2198 that would provide for further adjustments to ensure that the rate charged on deficiencies approximates as closely as possible the real borrowing cost of money.

Capital gains. The bill would require securities brokers to report transactions executed on behalf of their customers. In light of the extremely high rate of non-compliance for capital transactions generally, this proposal seems entirely appropriate. We also agree with the recommendation that copies of information returns filed with the IRS should be provided to taxpayers.

Barter Transactions. In recent years, there has been a considerable increase in the use of barter transactions between businesses to obtain services and equipment. Many of these transactions are carried out through organized barter exchanges. We believe that there is an important need for information reporting by such exchanges with respect to such transactions and that any compliance measure should include coverage of such transactions.

State and local income tax refunds. Under the bill, State and local governments that make payments of, or credit or offset, refunds of taxes of $10 or more during a calendar year would be required to report such amounts to both the recipient and the IRS. This information reporting requirement would be helpful. On the other hand, it would seem that the separate line on Form 1040 for State and local income tax refunds in itself provide a reminder for reporting of this item. In addition, a taxpayer should be able to refer to a copy of his or her prior year's State income tax return, as easily as an information return, to verify the amount of such refunds. Thus, the most important aspect of this proposal would seem to be the provision of information to the IRS, preferably through cooperative information exchange agreements, by which the IRS can check whether refunds have been reported on individual returns.

Charged Tips. Under this proposal, employers would be required to treat tips that are charged on credit cards as wages subject to information reporting. Prior to the Revenue Act of 1978, employees who received tips of $20 or more in a month were required to report all tips, including charged tips, to their employers, who in turn were required to treat reported tips as wages for purposes of income and social security tax withholding. In addition, under rulings issued by the IRS, employers were required to report to the IRS all charged tips paid over to employees and not reported to the employer, if the total amount of such tips along with wages and other tips subject to withholding and to reporting on W-2 aggregated $600 or more during the calendar year. The Revenue Act of 1978 reversed these prior rulings and eliminated the obligation of employers to report charged tips not reported by an employee.

The proposal contained in S.2198 to restore pre-1978 law is clearly a step in the right direction. As explained in the Technical Explanation of the bill, however, the reporting requirement would apply to employers who pay over to an employee charged tips aggregating $600 or more during the calendar year. It should be clarified that the reporting requirements also would apply if the combined wage income and charged tip income equals or exceeds $600 during the calendar year. Treas.Reg. § 1.6041-2(a)(1). In addition, given a compliance rate in the teens for tip income, in our view such charged tips should be subject to withholding as well as information reporting. Since a payment is being made by the employer to the employee and since such tips would be subject to reporting but for the employee's failure to report, treatment of such amounts as wages subject to income and social security tax withholding would be entirely appropriate.

Withholding on pension payments. Under the bill, the current system of voluntary withholding on the taxable portion of periodic pension and annuity payments would be strengthened by requiring withholding unless an individual affirmatively elects out of the system. In addition, withholding would be mandatory on total distributions from a qualified plan except in cases where the distribution is rolled over, tax-free, to another qualified plan or to an IRA. We agree that withholding should be required generally on the taxable portion of pension payments. In our view, however, an individual should be allowed to elect out of withholding on periodic payments only under the same circumstances that an employee may claim exemption from withholding -- that is, if the individual incurred no income tax liability for the preceding taxable year and expects to have no income tax liability for the current year. Such changes would make the proposed system simpler as well as more effective.

Penalty on Substantial Underpayments. The bill would introduce a new penalty that is intended to deter taxpayers from taking aggresive positions on their tax returns that have a low probability of being upheld on audit, but a high probability of escaping audit altogether. This so-called audit lottery penalty would increase the riskiness of noncompliance for taxpayers who gamble that they will not be called to account for taking such questionalbe positions. The penalty would apply in cases of substantial understatements of tax liability and would be 10 percent of the amount of the understatement. No penalty would be imposed, however, on a taxpayer who is uncertain about a position taken on a return, if the item has been adequately disclosed on the return. The penalty would be in addition to liability for the underpayment and any interest or existing penalties (other than the fraud penalty) thereon.

We fully agree with the thrust of S. 2198 that a balanced set of compliance measures must deal with the overreporting of deductions as well as the underreporting of income. It is essential to our system of voluntary compliance that all taxpayers take reasonable positions in reporting transactions on their returns and determining their income subject to tax. It is unacceptable for some taxpayers to be able to ignore this standard of reporting and, because of the IRS' low audit coverage, find little risk in doing so. Moreover, we agree that requiring disclosure of questionable positions is the remedy to this problem that is most consistent with the principles of our tax system. Given the complexity of returns and the ability of taxpayers to bury a questionable item even when a return is audited, we do not think that such a disclosure requirement gives the IRS an unwarranted advantage in auditing tax returns.

Our principal concern with the provision of the bill as drafted, however, is that it would apply in the case of any substantial understatement of tax liability, regardless whether the taxpayer had taken a reasonable position. We think that taxpayers who have adhered to a standard of reasonableness should not be subject to such a penalty. While we recognize that it may be difficult in particular cases to determine whether a position is reasonable, we believe nevertheless that the effort must be made to incorporate such a standard into this provision. Otherwise, the penalty will reinforce the concern among honest taxpayers that taxpayers who take unreasonable positions suffer no greater risks for doing so than other taxpayers who attempt as best they can to comply with the tax laws.

In conclusion, we commend the sponsors of S. 2198 for attacking the compliance problem in a well-considered and comprehensive manner. While we continue to believe that withholding is preferable to information reporting as a means of improving compliance in the reporting of certain types of income, we think this bill represents a significant step forward and will accomplish several important compliance objectives.

NAM

STATEMENT

ON BEHALF OF

THE NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

COMMITTEE ON FINANCE

U. S. SENATE

APRIL 12, 1982

This statement is submitted on behalf of the National Association of Manufacturers (NAM). NAM represents nearly 12,000 member firms who account for nearly 80% of the nation's industrial output and 85% of the nation's industrial workforce. We are pleased to submit for the record, the Association's views on S. 2198, the "Taxpayer Compliance Act of 1982".

NAM supports the basic thrust of S. 2198 which is to increase taxpayer compliance through the use of improved information reporting requirements and stricter penalties on those who violate the Federal tax laws. In addition, NAM believes that this approach, rather than a broad extension of the mandatory withholding system, is the proper way to attempt a comprehensive reform of the voluntary compliance system.

Although NAM agrees with the basic thrust of this proposal, we believe that the bill would be more effective if the following provisions were substantially modified or deleted. These provisions are:

1) Section 104- Information Returns.

2) Section 113- Restrictions on payment of interest for certain periods.

3) Section 121- Fraud penalty on corporate directors, officers, employees, and agents.

4) Section 125- Penalty for substantial understatement.

5) Section 202- Paperwork Reduction.

Form of Information Returns

Section 104 permits the Secretary of the Treasury to require the filing of tax returns on magnetic tape. NAM is concerned that this provision lacks any standards or criteria which must be utilized by the Internal Revenue Service in requiring machine readable or magnetic tape returns. In effect this provision authorizes the Service to require the filing of returns on magnetic tape, whether or not such tapes are regularly used in the taxpayer's business. NAM recommends that this provision not be adopted unless and until specific standards are set out in the statute.

Restrictions on Payment of Interest for Certain Periods

The NAM opposes Section 113(c) which denies interest to taxpayers for net operating loss or tax credit carrybacks. Current law allows a taxpayer to collect interest on a refund commencing from the first day of the taxable year following the year in which the loss or credit giving rise to the carryback occurs. Repeal of this provision will penalize those business taxpayers that have substantial losses and carrybacks and who have relied on this provision to maintain their cash flow. Repeal would also be inequitable as the IRS uses a similar interest provision to assess taxpayers whose tax liability is altered due to a subsequent interpretation of the law. This provision would set a different and unwarranted standard for the taxpayer and could be viewed as a special tax on loss companies.

Fraud Penalty

Section 121 imposes a civil penalty provision on corporate directors, officers, employees, and agents. NAM believes that this new penalty provision is unnecessary and will have a disproportionate effect on small business. Current law is more than adequate to deal with tax fraud cases. The United States Criminal Code provides severe criminal penalties for corporate officers convicted for corporate tax fraud. In addition to the Criminal Code, Federal law provides substantial civil restraints through the imposition of civil fraud penalties on corporations, and through shareholder derivative suits.

The addition of another civil fraud penalty directed towards corporate officers _per se_ is unnecesary and does little to deter improper corporate behavior.

The principal impact of this new provision will be on small, closely held corporations. Ordinarily, the officers and directors of these corporations are also the major shareholders. The enactment of a new civil penalty imposed against corporate directors, officers, etc. could result in the imposition of a double fraud penalty as the same individuals would be compelled to pay both the present corporate penalty and the new corporate officer's penalty. This might have a very serious and unwise effect on the willingness of individuals to serve as officers or directors of either large or small corporations since such individuals would be subject to potential personal liability - especially under a "should have known" standard of liability.

Finally, as to the larger publicly held corporations, this provision could be used by aggressive IRS agents to intimidate corporate employees into acquiescing to proposed audit adjustments of dubious merit.

Penalty for Substantial Understatement

Section 125 would impose a penalty of 10% of the amount of an underpayment of tax liability if the underpayment exceeded the greater of $5,000 for individuals / $10,000 for corporations _or_ 10% of the amount required to be shown on the return. In computing the understatement, items giving rise to a deficiency would be treated as having been reported properly and the full tax paid therein if the taxpayer adequately disclosed on the return or an attachment to the return that the reporting of the item was questionable. This provision is the most controversial and onerous feature of S. 2198.

This provision was placed in the bill to deal with the so-called "audit lottery" whereby some taxpayers take unreasonable deductions on the assumption that the chances of their return being audited are fairly remote. While the fixed 6% interest rate for audit deficiencies may not have provided sufficient deterrence, the current 20% rate and the proposed semi-annual compounding of interest should resolve the problem. The proposed penalty will impose an unreasonable and costly burden on the business taxpayer. Corporations will be compelled to prepare and file supplementary disclosure materials at great expense in order to comply with the law and to avoid substantial penalty. These documents will be compiled for the sole purpose of insulating the corporation from liability under this section. While the proposed penalty will not necessarily result in greater compliance by the taxpayer, it will of necessity result in additional paperwork and cost to the business taxpayer.

In addition, the proposed penalty places furtner unnecessary burdens on the business taxpayer. Corporate taxpayers already file Schedule M which sets out all tax return deviations from the corporation's financial books of account. Taxpayers cannot be expected to file required income returns by a prescribed date while simultaneously be expected to conduct an internal tax audit. This proposal places another obstruction in the path of those business taxpayers seeking to timely fulfill their reporting responsibilities under our self-assessment system.

Finally, the proposed penalty would have a chilling effect on the ability of taxpayers to contest IRS decisions on controversial provisions of the tax law. It is well established that the Internal Revenue Code is extremely complex and that even after IRS or Tax Court determinations, the law may still be unclear as to its applicablity to a particular taxpayer. It is not unusual, for example, to have different United States Courts of Appeals disagree on the appropriate interpertation of the tax law. The provision sets an extremely high standard of knowledge for the taxpayer and can only have the effect of deterring taxpayers from reasonably contesting IRS determinations.

Paperwork Reduction

Section 202 exempts the IRS from the recently passed Paperwork Reduction Act of 1980. The Office of Management and Budget has reported that of the total paperwork burden imposed upon businessman during FY1982, almost half (45%) will be imposed by the Department of the Treasury. The NAM opposes this proposed IRS exemption as contrary to the purposes and objectives of the Federal Paperwork Reduction Act which was to control and reduce the Federal paperwork burden. The NAM believes that the IRS should be just as accountable for paperwork management and control as any other agency within the Federal government.

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PAUL, WEISS, RIFKIND, WHARTON & CARRISON
1714 MASSACHUSETTS AVENUE, N.W. WASHINGTON, D.C. 20036
TELEPHONE (202) 822-1800 CABLE LONGSIGHT WASHINGTON

345 PARK AVENUE
NEW YORK, N.Y. 10154
TELEPHONE (212) 644-8000
TELECOPIER (212) 644-8202
TELEX WU 12-7031
WUI 666-843
CABLE LONGSIGHT N.Y.

8 PLACE VENDÔME
75001 PARIS FRANCE
TELEPHONE 261 41 45
TELEX 213649F
CABLE LONGSIGHT, PARIS

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April 1, 1982

Sen. Charles Grassley, Chairman
Subcommittee on Oversight
Senate Finance Committee
Room 232 Russell Building
Washington, D.C. 20510

Re: S2198 - Taxpayer Compliance Improvement Act of 1982

Dear Mr. Chairman:

I am sorry that a prior commitment made it impossible for me to participate in the Subcommittee's hearing on S2198 on March 11th. There are, however, a few comments which I hope will be useful in your further consideration of this very important bill.

In general, I believe the bill addresses critical problems of tax administration, and if enacted would significantly improve compliance with our tax laws.

The following are some specific comments on particular provisions of your bill.

1. Improved information reporting. My first preference for addressing the reporting gap in interest and dividend income would be a system of withholding tax at the source of payment. Absent withholding, however, improved and expanded information reporting could make a major contribution toward improving compliance. How much of a contribution to improving compliance depends, however, on the resources which the Internal Revenue Service will have available to process documents and, most importantly, to follow-up on apparent underreporting and non-filing.

Experience with wage withholding compared with information reporting demonstrates that withholding operates much more efficiently than information reporting. Withholding statements are more accurate and reporting by taxpayers of income subject to withholding more complete. The fact that taxpayers want to claim credit for taxes already paid through withholding produces very high compliance rates.

For an information reporting system to yield comparable results would require a very large expenditure of funds by the IRS to follow-up and resolve discrepancies and collect amounts found to be due.

Nevertheless, given adequate resources, expanded information reporting would improve compliance.

2. Penalties. I believe, by and large, the penalty provisions of S2198 are appropriate, although there may be technical problems involved in some of them.

I would like to comment particularly on the penalty for substantial underpayment. Under the bill, a taxpayer would incur a penalty for a substantial underpayment of tax unless the item causing the underpayment had been disclosed in the taxpayer's return.

There are two different types of noncompliance which are of serious concern in the administration of our tax system, one of which is adequatley addressed by this penalty provision and the other of which is not. For a taxpayer who engages in a transaction in the ordinary course of business and then faces a question of how to report that transaction on his tax return, the relief from the penalty by disclosure seems appropriate.

On the other hand, relief by disclosure seems inappropriate for taxpayers who enter transactions for the primary purpose of claiming deductions on their tax returns, frequently with the knowledge that they will succeed in reducing their taxes only if their returns are not selected for audit. A major administrative problem facing the IRS today results from the proliferation of such tax shelter schemes, with over 250,000 cases now in the pipeline. In virtually all of these cases the taxpayer's return does, in fact, disclose the transaction. The taxpayer is claiming deductions based on the transaction.

The goal of a penalty in the tax shelter area should be to discourage taxpayers from entering transactions in the first place where the claimed positions are very questionable. Taxpayers will only be discouraged if they have something to lose from entering transactions, the primary purpose of which is to play the audit lottery, other than the tax and what historically has been a reasonable rate of interest. The problem is that the ticket to the audit lottery is free. If the taxpayer is not audited he has succeeded in unjustifiably reducing his taxes. If he is audited he pays the tax he should have paid in the first place.

I would therefore suggest that the provision relating to this penalty provide that the penalty will not apply if two conditions are met: (a) there is full disclosure; and (b) the transaction giving rise to the disputed item had a substantial business, other than tax, purpose. I am not recommending this particular formulation of the test, only that the test should encompass these two ideas.

3. Regulations and paper work reduction. I strongly support the provision to exempt Internal Revenue Service rules and regulations from approval by the Office of Management and Budget. The net result of this review has simply been to create more paper work and slow down the issuance of rulings and regulations which taxpayers desperately need. The complaint of taxpayers is that there are too few regulations issued rather than too many. Certainty in tax matters is important and the regulations provide that. Moreover, the Office of Management and Budget simply does not have the expertise to provide adequate review.

Thank you for the opportunity to comment on this bill.

Sincerely yours,

Jerome Kurtz

JK/jg

Statement of Daniel K. O'Connell
Before The
Senate Finance Committee
Regarding S.2198, Taxpayer
Compliance Improvement Act of 1982

Mr. Chairman, Members of the Committee, I am Daniel K. O'Connell, Executive Vice President - Corporate Affairs of Ryder System, Inc. Ryder is engaged principally in truck leasing and renting, truckstops operation and specialized highway transportation. We wish to bring to the Committee's attention certain concerns and suggestions we have relating to the structure and operation of Section 125 of S2198, "Taxpayer Compliance Improvement Act of 1982".

Section 125 would add a new penalty to the Code. The penalty would be ten percent of the amount of any underpayment of tax arising, in effect, from an item not disclosed in a tax return. The penalty would apply to individuals only where the underpayment exceeds the greater of $5000 or ten percent of the amount of tax required to be shown on the return. In the case of a corporation, the threshold amount would be greater of $10,000 or ten percent of the tax required to be shown on the return.

In general, our position relative to this proposed penalty provision has previously been expressed to the committee by others. That is, the provision has surface appeal, but it is fundamentally wrong. Although the intention of the provision is commendable - - discouraging taxpayers from taking outrageous positions - - the effect will be a 10% surcharge on audit deficiencies largely borne by those who are innocent of such a motivation.

The proposal makes no distinction between deficiencies created by taxpayers playing the "audit lottery game" and deficiencies resulting from the uncertainties of business judgement built into the Internal Revenue Code. For example, taxpayers are allowed a deduction for "reasonable" compensation, "reasonable" additions to a reserve for bad debts, "arms length" income and cost allocation between related parties and a current deduction for "repairs" but must capitalize "improvements". These and a great many other items are the subjects of judgements as to which reasonable men may differ. To make audit deficiencies relating to such matters subject to an "audit lottery" penalty is unfair. Furthermore, how does a taxpayer "disclose" such an item when the deduction claimed, based on the taxpayer's best business judgement, is perceived to be proper and not expected to give rise to an IRS deficiency?

To the extent the ten percent penalty tax is applied to items which are of a timing nature, such as adjustments to a bad debt reserve and capitalized repairs, the imposition of interest plus a negligence penalty in egregious situations provides adequate penalty to taxpayers taking extreme positions.

Furthermore, when these timing items reverse equity would dictate that taxpayers should then receive a refund of the penalty tax on such items. The proposal contains no such mechanism.

Mechanically the proposal includes a ten percent margin for error, but that safety net is removed in its entirety once tax deficiencies exceed that level. This procedure is not equitable and we feel that the ten percent threshold should be left in when computing the penalty tax.

The burden that this provision would place on businesses who seek to minimize the risk of penalties would be onerous. The small business man would be forced to go to great lengths to have his books and records subject to an annual "tax audit" by his outside tax advisors and auditors to assure himself that exposure to the ten percent penalty tax is minimized. Likewise, larger businesses would need to increase their internal staffs and employment of outside advisors so that they too could perform an annual "tax audit". In both cases, business efficiency and productivity will suffer. It is this type of non-productive mandatory cost which threatens to impose a permanent inflation factor into our economy.

Finally, we do not believe the proposal will achieve the desired result. Taxpayers currently walking the thin line between proper compliance and fraud by playing the "audit lottery game" may not be discouraged from continuing such tactics as the potential tax savings will have increased by ten percent. Furthermore, tax litigation is likely to increase dramatically because the potential tax savings from favorable decisions or compromises will have materially risen.

In summary, we feel the underlying concept of the proposal has merit - - that is minimizing the revenue loss from taxpayers unjustifiably playing the "audit lottery game". However, we feel the specific proposal will have the effect of causing the majority of taxpayers to incur a significant unproductive administrative burden and bear the risk of unjustified ten percent surcharges on good-faith tax deficiencies.

Peat, Marwick, Mitchell & Co.

Certified Public Accountants

1990 K Street, N.W.
Washington, D.C. 20006

**Statement by Peat, Marwick, Mitchell & Co.**

**with respect to**

**S.2198 - Taxpayer Compliance Improvement Act of 1982**

**on which a hearing was held March 22, 1982**

We wish to express our concerns with the proposal in S.2198, which would limit interest on an overpayment from a net operating loss or credit carryback. In our view the proposal disturbs the equitable balance between the government and taxpayers established by Congress more than 25 years ago and places substantial administrative burdens on taxpayers. We think you can deal with this matter without creating such adverse consequences.

Under present law, interest is payable on a carryback claim starting from the close of the taxable year which generated the loss or credit carryback. However, a claim cannot be submitted until the return is filed. Under your proposal, an overpayment would be deemed to have occurred only as of the date the carryback claim is filed. Hence, interest would be payable only from the date the claim is filed. Also, a return would not be treated as filed "until it is filed in processable form." Finally, the provision would be effective for interest paid after the date of enactment of the legislation except that interest accruing prior to March 11, 1982, would not be affected.

The present rule has been in the Internal Revenue Code for over 25 years and was added to treat taxpayers and the government on a consistent basis for computing interest on refunds and deficiencies. Furthermore, the present condition, i.e., the statutory interest rate exceeds the market rate, may well be a phenomenon peculiar to 1982. We believe that this proposal will again create an inequity in favor of the government.

Moreover, the proposal raises the specter of tremendous tax return preparation problems for corporations which must accumulate the data for the return and for the preparers of such returns. In fact, as a result of this unanticipated proposal, we have already received many requests by our corporate clients with 1981 losses to immediately prepare and file their 1981 Federal income tax returns so that they may file their carryback claims for refund and preserve the right to receive the full amount of interest allowed by present law. We believe this burden on tax preparers will increase when the proposal becomes generally known and that the government may experience a problem in timely processing an accelerated filing of claims.

We suggest that the interests of orderly administration of the tax rules would be ill-served by this rush to file, especially in light of what we perceive to be the primary motivation for the proposal. You are apparently concerned that taxpayers are intentionally delaying the filing of their carryback claims because the Internal Revenue Code section 6601 interest rate of 20% exceeds the present prevailing market interest rate. While it is certainly true that taxpayers would rather receive than pay the 20% interest rate, your proposal to completely eliminate interest until the claim is filed assesses a penalty against taxpayers that far exceeds any perceived abuse.

For Congress to change a long-established rule to correct a perceived imbalance which may exist for only one year, seems to us an overreaction. The potential for this situation to reoccur in later years should be minimal under your further proposal to adjust interest semi-annually. Therefore, we suggest that the restriction on payment of interest aspect of your proposal be abandoned. However, if the Committee still believes that the situation this year needs correction, then the proposal should be modified so that interest would run from January 1, as under present law, and be payable not at 20% but at some lesser rate to neutralize the perceived advantage of delaying the filing of refund claims. We do not agree that this latter suggestion is the correct approach. However, we would prefer it to the complete elimination of interest presently proposed in S.2198, which we believe is an unwarranted penalty against corporations that have incurred losses.

Thank you for the opportunity to present our views on this most important matter.

March 24, 1982

PEAT, MARWICK, MITCHELL & CO.

Daniel F. Kruger

Daniel F. Kruger
Partner-in-Charge
Washington National Tax Practice

STATEMENT OF THE

SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman and members of the committee. The Securities Industry Association appreciates the opportunity to comment on S.2198, the "Taxpayer Compliance Improvement Act of 1982."

SIA represents nearly 550 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 32 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporation and governmental units at all levels.

SIA applauds and wholeheartedly endorses the basic thrust of the proposed legislation aimed at closing the "tax gap" attributable to non-compliance with the Federal income tax laws, which according to IRS estimates is rapidly approaching the $100 billion mark. As Congress and the Administration seek to narrow triple-digit budget deficits in the next several fiscal years, it behooves the government to give top priority to the pursuit of taxpayers who do not pay their fair share of the tax burden. Our self-assessment system cannot exist without voluntary compliance by all taxpayers. Substantial noncompliance destroys the fabric which holds that system together, namely taxpayers' perception of its fairness and their conviction that everyone else also carries his or her share of the tax burden.

Since efforts to close this tax gap will impose additional responsibilities not only on taxpayers but also third party payers, steps to increase compliance must be realistic in terms of both economics and operational feasibility.

The proposed legislation, in so far as it pertains to the securities industry, contains four relevant elements: (1) information on bearer instruments heretofore exempt from the information return requirements; (2) reporting on securities and commodities transactions; (3) mandatory magnetic tape reporting; and (4) revision of the structure of penalties relating to information returns. We would like to offer our comments with respect to each of these ingredients.

BEARER OBLIGATIONS

The bill would expand information reporting requirements to include interest (including original issue discount) on all corporate bearer obligations and obligations of the United States, its agencies, and instrumentalities. The proposal would apply to all interest payments and original discount reportable on calendar year 1982 and subsequent information returns. The mechanics of the proposed reporting requirements are not specified in the bill, but would be prescribed under regulations to be issued by the Secretary of the Treasury.

The Internal Revenue Service has not yet released any study specifically focusing on compliance by holders of bearer obligations. Before the Congress considers any further reporting and/or withholding requirements covering unregistered obligations, the Treasury Department should be required to convincingly demonstrate the extent and magnitude of taxpayer noncompliance in this area, in order for policy makers to evaluate whether additional costs and efforts imposed upon the private sector are justified.

Most of the obligations to be subject to the expanded reporting system are held by government entities (including the Federal Reserve System), banks and other financial institutions, insurance companies, pension funds, and other institutional ~~investors.~~ Excluding savings bonds, an estimated $665.2 billion of Treasury issues alone was outstanding in 1980, with little more than 20 percent held by households. Given the large institutional holdings of these obligations and the meager portion held by households, imposition of reporting requirements on these instruments would do little, if anything, to close the compliance gap. On the other hand, a reporting system encompassing these holdings would generate a blizzard of information for the IRS, the usefulness of which is questionable.

The imposition of reporting requirements for these instruments would require the development of new tracking and record-keeping procedures by the securities industry and other financial intermediaries. For example, the interest element on many discount obligations in secondary market transactions is a component of the purchase or sale price and not separately reported to accounts at present. In addition, reporting the ratable portion of original issue discount realized on intermediate sales in the secondary market would pose formidable problems, especially where the purchase and sale were handled by two different intermediaries. The scope, complexity, and cost of new reporting procedures would depend on the nature of the reporting rules, which have yet to be defined. Since neither the bill nor the technical explanation accompanying it provide any guidance as to the mechanics of the proposal, we are unable to offer any comments or suggestions concerning its operational feasibility, potential effectiveness, or implementation costs, at this time. This is a serious shortcoming on the part of those supporting the proposal because it precludes constructive suggestions on making any reporting system as efficient as possible.

Because the reporting on bearer obligations is fraught with complex technical issues, we urge the committee not to initiate legislation before consulting with technical experts in the industry. SIA has indicated a willingness to form a group of industry operational, data processing and accounting experts to meet with congressional committee and Treasury staffs in developing explicit legislative proposals in this area.

In view of the need for clarification of the new reporting requirements, we consider the calendar year 1982 effective date for these reporting requirements to be unrealistic. The requirements should be applied prospectively, after giving full consideration to the lead time required by the financial services industry to gear up for the new rules and by the Internal Revenue Service to change its forms, instructions, and computer programs to effectively utilize the information to be provided.

CAPITAL TRANSACTIONS REPORTING

S.2198 and H.R. 5829 would expand the requirements for informati reporting by brokers to include capital gains in commodities and securities transactions.

The administration claims that the federal government is short-changed by over $9 billion annually as a result of discrepancies in the reporting of capital gains. Supposedly, out of every tax dollar due on transactions resulting in capital gains, only 56 cents is being voluntarily reported. Neither the facts these estimates are based on nor the technical methodology used to develop these calculations have been released to the public. Undoubtedly, the figures include capital gains on real estate transactions, collectibles, depreciable property used in trade or business, and a host of other transactions unrelated to securities or commodities. It also seems plausible that these estimates encompass not only errors of omission, but also errors of commission, such as using an incorrect tax basis for the property sold or reporting the gain in the wrong year. Also to be considered is the wide spectrum of technical and interpretative issues which, we believe, predominate the field of capital gains controversies between taxpayers and the Internal Revenue Service. In short, the target of the proposal, i.e. omitted securities and commodities transactions, represents only a small portion of the purported $9 billion gap.

There is no doubt that reporting of capital gains or proceeds of sales would impose an enormous record-keeping burden on the industry. To gauge the magnitude of the proposal, consider that on an average day in 1980, an estimated 85,000 organized stock markets securities transactions were executed for the individual investor only. Capital gains calculation at present is done by very few firms and only rarely for special accounts. An awareness of the inability of firms to provide this information is evidenced by the proposal to report gross proceeds of sales. Unlike dividend and interest reporting, this is not simply a matter of totaling debits and credits at year-end. Until such time as the details of the reporting requirements are spelled out, we are unable to estimate the impact on the industry's operations and costs. However, these costs in time and money would be substantial and should be weighed against the IRS's ability to process countless new documents in order to collect significant revenues. The data released to date do not indicate how much of the $9 billion gap the proposed system would close, particularly since the proposal is limited to securities and commodities transactions, two areas where we believe compliance in reporting gains is considerably higher than for other assets.

MANDATORY MAGNETIC TAPE REPORTING

The bill would authorize the Secretary to require the filing of information returns on magnetic tape. SIA recognizes that substantial economies are realized by the Internal Revenue Service when information documents are submitted in magnetic tape form. For many years IRS has promoted magnetic tape reporting by payers on a voluntary basis and its field coordinators have been highly successful in persuading large payers to submit documents in magnetic tape mode. We understand that as a result of these collaborative efforts in calendar year 1978, the most recent period for which data is available, over 89 percent of Forms 1087-DIV (the form most commonly filed by our member firms) were filed on tape. Presumably the percentage is even higher today.

We believe that a continuation of these time-tested administrative efforts is a better way to stimulate magnetic tape reporting than mandatory legislation. Many small broker-dealer firms lack computer filing capability and would be financially hard-pressed to comply with mandatory tape reporting requirements. In addition, their market share is probably too small to justify the additional costs and burdens which would be imposed on them.

PENALTIES

We agree with the provisions of the bill to increase from $5 to $50 the penalties for failure to file information returns, and for failure to furnish taxpayer identifying numbers (TIN), or to include them on the appropriate returns or statements required under the law.

Our endorsement of these stepped up penalties, however, is contingent on the continuation of existing IRS administrative appeals procedures, under which taxpayers seeking to establish reasonable cause enjoy full appeal rights before the Appeals Division, after assessment but prior to payment of the penalty. We urge that the committee's report contain language expressly incorporating this condition.

We have serious reservations about the proposed penalties triggered by "intentional disregard" of the filing requirements or the requirement to include a payee's TIN on an information return. These penalties are intended to parallel those contained in Section 6694 of the Internal Revenue Code relating to tax return preparers. If so, the burden of proof would be upon the taxpayer to establish that he did not "intentionally" disregard the statutory requirements. This burden, coupled with the potential magnitude of the assessments (the failure to file penalty is fixed at not less than 10 percent--5 percent in the case of reports of brokers--of the aggregate of the items not properly reported) could well place innocent taxpayers in dire financial jeopardy. We believe that increasing the existing civil penalties under sections 6652 and 6676 to $50 per failure, with a maximum of $50,000, will provide ample incentives to compliance. Superimposing an additional and even more severe set of civil penalties on these increases is unnecessary and, at best, premature. Moreover criminal provisions of the code are already available to deal with willful and flagrant violations.

If the committee finds it necessary to incorporate the "intentional disregard" sanctions in the legislation, in spite of these considerations, we urge that the statute explicitly mandate that the IRS grant the taxpayer full administrative appeal rights prior to assessment of the penalty. Further, the statute should contain language similar to Section 6694(c), allowing taxpayers to seek judicial review on the basis of partial payment of the penalty assessment.

The Securities Industry Association supports the proposal to withhold a 15 percent tax from interest and dividends credited to a customer's account where the customer failed to supply a TIN or provided an incorrect TIN to the brokerage firm. However, we do not believe that the withholding tax should also be applied to proceeds of sales from commodities or securities transactions, since such tax would be confiscatory where the transaction resulted in a net loss or in a realized gain amounting to less than the proposed tax to be withheld.

CAPITAL GAINS HOLDING PERIOD

SIA strongly supports the reduction of the capital gains holding period, a proposal which would not impose a burden on the securities industry or the individual investor. Most importantly, a recent survey conducted by Opinion Research Corporation for SIA showed that the one-year holding period has lost revenues for the Treasury in the past two years. One-third of the surveyed executives reported an average decline of $15,700 in the value of assets that they planned to sell for long-term capital gains. In the second six months of ownership, assuming that only 10 percent of all taxpayers in the same income group ($50,000-$100,000) experienced similar trends in capital gains, the estimated Treasury revenue loss ranges between $470-$590 million. This is in striking contrast to the $350 million "static" gain estimated by government staff in 1976 to be derived from lengthening the holding period from six months to one year.

Based only on the executives in our survey -- without extrapolating to the universe of investors -- the increased investment stimulated in eleven asset choices is most impressive. During the first year of a six-month holding period, new or increased common stock investment alone would be $4.1 million. Assuming that 10 percent of all taxpayers in the same income class as the surveyed executives would follow similar investment behavior, the total increased investment would be around $50 billion during the first year. While this figure may seem staggering, it represents just 7.5 percent of the increase in personal financial holdings from 1979-80.

We have long believed that selective removal of tax disincentives on investment can generate favorable developments for the economy. The capital gains tax cut in 1978 supports this belief. There is little dispute that this cut led to increased tax revenues in 1979. Recently released preliminary IRS income data show that sales of capital assets in 1980 were virtually the same as in 1979, suggesting that the stimulative effect of the tax cut led to increased capital gains revenues in 1980 as well. Of course, there are many other trends (new issues, venture capital, etc.) which document the successful track record of the 1978 capital gains tax cut.

CONCLUSION

Before Congress requires information returns on bearer obligations, it should have convincing evidence as to the extent and magnitude of taxpayer noncompliance in this area.

Most of the transactions in bearer instruments are conducted on behalf of government entities, banks and other institutions. To require information, reporting would create a blizzard of paperwork for securities firms as well as the IRS, the usefulness of which is very questionable. There is little doubt, however, that any new reporting requirements should be applied prospectively rather than retroactively to calendar year 1982.

The proposed reporting of capital gains transactions or proceeds of sales will burden the industry with additional costs and procedures. Before any effort is launched in this area, Congress and the industry should have evidence that the proposal will close a substantial portion of the $9 billion gap. Estimate of costs in time and money of any of these proposals will vary greatly depending on the size of the firm, its computer capabilities, and customer base. SIA stands ready to have industry professionals discuss these two proposals with appropriate Treasury and congressional staff.

SIA opposes mandatory magnetic tape reporting and urges that continued emphasis be placed upon IRS promotion efforts which have worked so successfully in the past. As to penalties, we support increasing the civil penalties for failure to file information returns or supply taxpayer identifying numbers (TINs). We also support the proposal to withhold 15 percent from interest and dividends paid to taxpayers who fail to supply TINs or furnish incorrect TINs. We oppose a withholding from the proceeds of securities or commodities transactions on grounds that such withholding could well be confiscatory. We also oppose as unnecessary and premature enactment of a new set of penalties for "intentional disregard" of certain filing and reporting requirements. SIA stands ready to work closely with the Congress and its staff in trying to close the compliance gap without imposing unrealistic and unnecessary burdens on the private sector.

# Tax Executives Institute, Inc.

14th Floor, 1616 North Fort Myer Drive
Arlington, Virginia 22209
Phone-703/522-3535 Telex 89-9164



April 8, 1982

The Honorable Robert J. Dole
Chairman, Senate Finance Committee
United States Senate
2213 Dirksen Senate Office Building
Washington, D.C. 20510

Re: S. 2198 "The Taxpayer Compliance Improvement Act of 1982"

Dear Mr. Chairman:

Tax Executives Institute, Inc. ("TEI") is an organization with approximately 3,800 individual members representing over 1,100 of the leading corporations in North America. Membership in TEI consists of persons employed by corporations who are charged with the administration of the tax affairs of their employers in an executive, administrative or managerial capacity.

As an organization dedicated to the principle of fair and equitable adminstration of and compliance with the nation's tax laws, TEI is deeply concerned about the large amount of unreported income that is reputed to exist in the "underground economy". Consequently, we strongly support the basic objectives of S. 2198. However, we also feel strongly that some sections of the bill are either unadministrable or would cause unwarranted financial costs to be incurred by law-abiding corporate taxpayers. Some proposals in the bill would clearly result in a significant overkill and would serve to portray the multitude of honest corporate taxpayers who are fully complying with the law in the same adverse light as the "underground economy". We do not believe that such results were intended by the sponsors of the bill and respectfully request that such sections be reconsidered.

Because the short period of time between the introduction of the bill and the hearings did not allow us to prepare for and request time to testify, we are hereby submitting our written comments on three proposals in the bill which we feel lack merit and which should not be adopted. We hope that our comments will be helpful to you and your Committee and that they adequately demonstrate the need for changes in the bill.

If the Subcommittee on Oversight of the Internal Revenue Service decides to hold additional hearings on S. 2198, we respectfully request an opportunity to present oral testimony in addition to the above written comments. We would be most pleased to provide any assistance in these matters that you would feel to be helpful.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

Thomas P. Maletta

Thomas P. Maletta
President

cc: All members of the Senate Finance Committee

Robert Lighthizer

Mark L. McConaghy

STATEMENT OF

TAX EXECUTIVES INSTITUTE, INC

ON S. 2198

THE TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1982

SECTION 113 -- RESTRICTIONS ON PAYMENT OF INTEREST FOR CERTAIN PERIODS

Paragraph (c) of this section of the bill would eliminate the present requirement that the Internal Revenue Service pay interest to a taxpayer on a tax refund due to a net operating loss, capital loss or investment credit carryback for the period beginning with the date of the close of the taxable year in which the carryback item arose and ending with the date the money is actually paid to the taxpayer. The bill would preclude a taxpayer from earning such interest until the entire completed tax return and claim for refund are filed with respect to the taxable year of the loss or in which the excess credit arose.

TEI believes that this is a totally inequitable proposal. The larger corporations, most of which are multi-divisional, multi-company and multi-national, simply cannot collect and properly analyze the tremendous volume of data which is required to file a complete and proper tax return much before the eight and one-half month period (including extensions) presently allotted for timely compliance. The thousands of transactions involved and the complicated laws and regulations governing them just will not normally permit an earlier filing. All the economic events which create the tax refund have occurred by the end of the taxable year and to deny a taxpayer interest on the tax refund legally due him during this period would be a major injustice.

Under all other similar conditions when either a taxpayer or the Internal

Revenue Service owes the other money interest is paid to the creditor involved. This includes interest paid to the Internal Revenue Service on audit adjustments arising out of court decisions rendered or new Regulations published several years after a tax return has been filed. It would be totally inequitable to make a unilateral exception in favor of the government when a taxpayer merely requires time to properly comply with the many tax laws affecting it.

If the objective of this sub-section of the bill is to eliminate the small advantage that the present 20% interest rate paid by the Internal Revenue Service has over the present market rate and to encourage taxpayers to file their returns and refund claims as soon as possible, then we believe that such an objective will be achieved by Sections 111 and 112 of the bill. These sections provide that the Internal Revenue Service interest rate will be determined semi-annually and computed on a compound basis, rendering paragraph (c) of the Section 113 totally unnecessary. Once an appropriate interest rate is established, any problems which currently exist will disappear.

Thus, in our view, paragraph (c) is unwarranted and should be deleted from Section 113 of the bill.

SECTION 121 -- FRAUD PENALTY ON CORPORATE DIRECTORS, OFFICERS, EMPLOYEES AND AGENTS

This section would impose a personal financial penalty on the individual directors, officers, employees or agents of a corporation who knowingly participate in tax fraud on behalf of a corporation resulting in a tax deficiency by the corporation. Such penalty would be an amount equal to 50% of the part of the underpayment of corporate tax attributable to the conduct of the individual, with a maximum of $100,000 per individual for each return. TEI is very proud of the compliance record of the corporate tax adminsitration profession and our Standards of Conduct would not permit any member convicted of tax fraud to remain in the Institute. However, we feel that the existing criminal tax fraud penalty, the threat of stockholder derivative suits and other sanctions (e.g., employee termination) already provide sufficient deterrents to public corporation tax fraud.

The number of cases where public corporations have been accused of engaging in tax fraud has been minimal and the number of cases where such corporations have been convicted of wrongdoing has been extremely rare. We understand that only 5% of the "noncompliance gap" is due to the corporate sector, and suggest that only a minor part of this 5% is attributable to public corporations. We are at a loss to see how this additional penalty would serve any substantial useful purpose or raise any additional revenue for the government. On the other hand, it certainly could be used as a type of Sword of Damocles by IRS auditors dealing with individual corporate officers or employees.

Proposed Code Section 6653(f)(3)(A) states that "knowing participation in fraud" includes participation with respect to which such individual "knew, or should have known, that such participation would result in an underpayment of tax". This is a sweepingly broad and imprecise standard and could surely result in penalties being proposed as to people who, at the time, acted in good faith but who, many years later and with the benefit of hindsight, are found to have made poor judgments. The proposed penalty could decrease the fairness of our extremely complex tax system by inhibiting responsible corporate tax officers and employees from taking positions on complicated tax issues which they feel are correct but which may be attacked later by the Internal Revenue Service. Since an officer or employee of a publicly held corporation (who is not a large shareholder therein) would receive no personal financial benefit from the corporation underpaying its taxes, it would seem unfair to financially penalize the individual for his actions as an employee.

Because of the lack of a demonstrated problem which requires solution, the existence of sufficient penalty provisions, the broad and imprecise standard being suggested, and the possibility of intimidation of private sector personnel by government auditors, we believe Section 121 is unwarranted and should be deleted from the bill.

SECTION 125 -- PENALTY FOR SUBSTANTIAL UNDERSTATEMENT OF TAX

As it relates to corporations, this section of the bill would impose an additional penalty in an amount equal to 10% of the amount of any underpayment of tax arising, in effect, from any item of adjustment not specifically "disclosed" in the tax return where the total underpayment exceeds the greater of $10,000 or ten percent of the corrected tax liability. The penalty would be imposed without regard to fault or the nature of the adjustment items if the items to which the tax deficiency is attributable are not specifically disclosed on the return.

Underpayments of tax by larger corporations are generally due largely to highly judgmental adjustments by the Internal Revenue Service, the general categories of which are set out on the return; however, because of the large volume of the individual transactions, such items are not specifically identified in detail. Such controversial items commonly include amounts capitalized by the Internal Revenue Service which are treated on the return as expenses, useful lives for depreciation purposes, the proper amount of reserve for bad debts, valuation of inventories, and the proper amount to accrue for various liabilities. Such adjustments can temporarily produce significant tax deficiencies. However, because of the uncertainty that has traditionally existed concerning the proper treatment of such items, there should be no penalty imposed if the taxpayer has a reasonable basis for its position. In these times of diminished business income, the safe harbor threshold amounts and percentages offer little solace to the corporate taxpayer.

In regard to the suggestion that perhaps "unusual" items be specially flagged on the return, it is pointed out that the Internal Revenue Service already requires that corporate taxpayers reconcile, in detail, all differences between the company's financial statements and its tax return on what is known as "Schedule M".

Considering the substantial nature of the existing negligence and fraud penalties and the fact that the bill will otherwise ensure that current interest rates are paid on deficiencies, TEI believes that sufficient deterrents to the so-called "audit lottery" already exist, insofar as publicly held corporations are concerned. Furthermore, approximately 1000 of the large corporations in the United States have historically been examined every year by the Internal Revenue Service under the Coordinated Examination Program (more commonly referred to as the "large case audit program"). Accordingly, there is no audit lottery for large corporations. Therefore, we request that Section 125 be deleted from the bill.

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