HEARING BEFORE THE UNITED STATES SENATE

COMMITTEE ON FINANCE

"The $350 Billion Question: How to Solve the Tax Gap"

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Chairman Grassley, Ranking Member Baucus, and Members of the Committee, as the new Treasury Inspector General for Tax Administration (TIGTA), I appreciate the opportunity to appear before you today to discuss the scope, size, and nature of the tax gap problem, as well as recommendations for closing the tax gap. I will also discuss the cash economy. Lastly, I will cover issues the Internal Revenue Service (IRS) faces in achieving a balance between its specific enforcement initiatives and protecting taxpayer rights, as well as maintaining and improving customer service.

In my opinion, the importance of these issues cannot be overstated. The nation's ability to provide for the general welfare and protect its citizens is based on the ability to raise revenue through taxes. For our government to perform effectively, it must ensure that the taxes owed are timely paid. Because the tax gap poses such a significant threat to the integrity of our voluntary tax system, one of my top priorities for TIGTA is to identify opportunities for improvements to IRS tax compliance initiatives.

Before I discuss the scope, size, and nature of the tax gap problem, I would like to provide a brief historical perspective of the tax gap, identifying some key points of reference in the evolution of this discussion. In testimony before this committee in March 1982, then IRS Commissioner Roscoe Egger stated, "The tax gap has been a problem for years, but recently the dollars involved have reached alarming levels."[1] He further declared that the total legal sector tax gap had risen from $29 billion in 1973 to $87 billion in 1981 (in 2001 dollars, these figures indicate a rise from $115.6 billion in 1973 to $169.4 billion in 1981). Although these are significant figures, they are dwarfed by the latest IRS tax gap estimate of between $312 and $353 billion for tax year (TY) 2001. When Commissioner Egger testified, he described the various components of the tax gap, some of which are still problematic in terms of compliance, including:

- Farm and Non-Farm Businesses;
- Partnerships and Electing Small Business Corporations;
- Nonfilers; and,
- Corporations.

A few years after Commissioner Egger's testimony, the Government Accountability Office[2] (GAO) issued a report identifying the IRS estimate for individual unreported income as the largest single component of the tax gap at $48.3 million in 1987.[3] Unreported income by sole proprietorships made up the

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[1] *Hearings on the Compliance Tax Gap Before the Subcomm. on Oversight of the Internal Revenue Service Comm. on Finance*, 97th Cong. (1982) (statement of Roscoe L. Egger, Jr., Commissioner of the Internal Revenue).
[2] Then known as the General Accounting Office. *See* GAO Human Capital Reform Act of 2004, Pub. L. No. 108-271, § 8, 118 Stat. 811, 814 (2004).
[3] GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-88-66BR, TAX ADMINISTRATION: IRS' TAX GAP STUDIES (1988).

largest component of that figure, at 34 percent. In 1994, the GAO issued another tax gap report indicating that although many corrective actions were taken, a cohesive strategy was needed to address compliance issues.[4] This report indicated that noncompliance threatened our tax system. The GAO cited declining audit rates, problems with modernizing IRS systems, and issues with data used to measure compliance as significant concerns facing the IRS. Additionally, GAO identified actions the Congress could take to provide the IRS with more compliance tools. More than a decade later, these same concerns still confront tax administration.

The following year, in 1995, GAO reported on a tax gap symposium that was held to explore innovative yet practical means for increasing taxpayer compliance by bringing together experts in this field.[5] The impact of tax law complexity on voluntary compliance was a key issue discussed at the forum. Additionally, the forum discussed proposals to reduce levels of underreporting by increasing the visibility of income and tax withholding. Some of these proposals are still viable, and will be included in my discussion on recommendations to close the tax gap.

Over the decades the tax gap has been an issue, the Congress has taken action to address various components of the tax gap. For example, the Tax Equity and Fiscal Responsibility Act of 1982[6] was enacted, in part, to address tax shelters involving partnerships. The Deficit Reduction Act of 1984[7] contained provisions to combat corporate tax abuses. The Tax Reform Act of 1986[8] extensively revised the tax code to eliminate tax abuses and create a more equitable tax system.

I have provided this historical perspective to emphasize the fact that the tax gap is not new. Making the difficult changes necessary to address the tax gap is something that the IRS, the Department of the Treasury, and Members of Congress will have to continue to wrestle with to help remedy this problem.

My remaining testimony will focus on the scope, size, and nature of the tax gap, the resulting implications of the growing cash economy on the tax gap, recommendations for closing the tax gap, and finding the appropriate balance among enforcement, taxpayer rights, and customer service.

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[4] GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-94-123, TAX GAP: MANY ACTIONS TAKEN, BUT A COHESIVE COMPLIANCE STRATEGY NEEDED (1994).
[5] GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-95-157, REDUCING THE TAX GAP: RESULTS OF A GAO-SPONSORED SYMPOSIUM (1995).
[6] The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982) (codified in scattered sections of 26 U.S.C.).
[7] The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) (codified as amended in scattered sections of 26 U.S.C.).
[8] The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified in scattered sections of 26 U.S.C.).

The Tax Gap: Its Scope, Size, and Nature

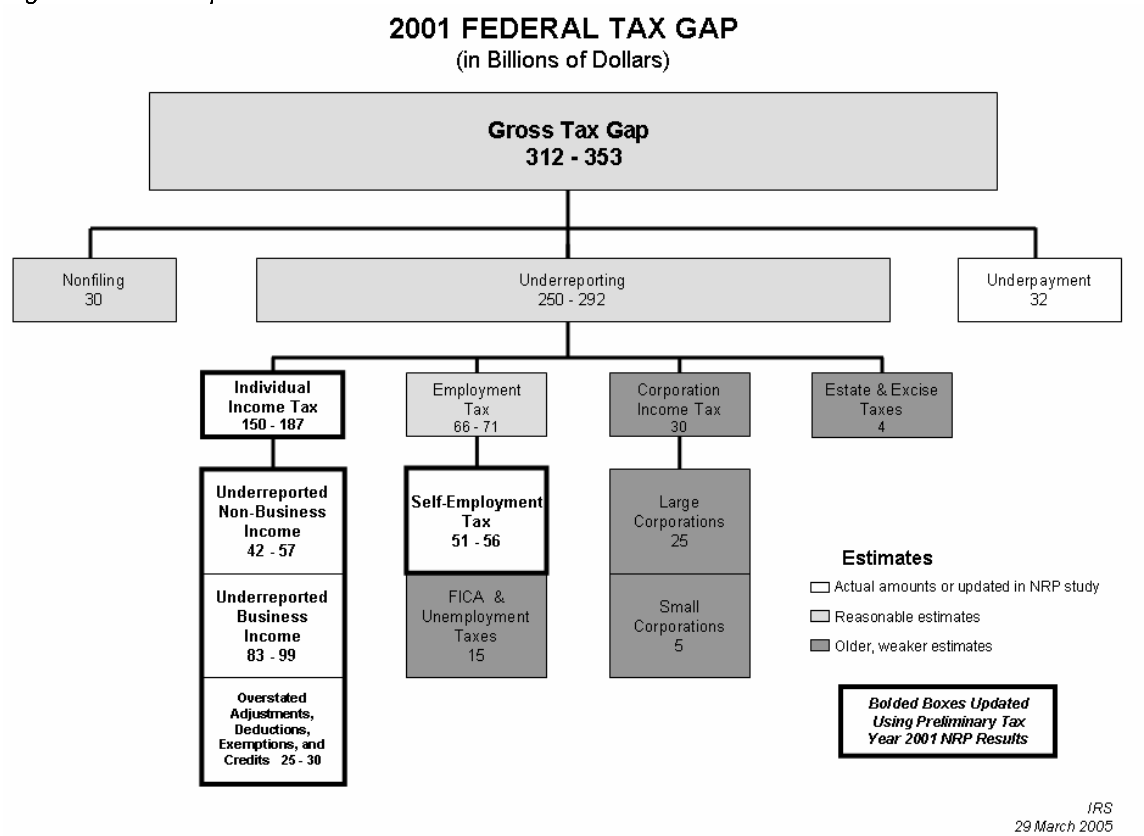
The IRS defines the tax gap as "the difference between what taxpayers are supposed to pay and what is actually paid."[9] The IRS further describes the tax gap as having three primary components — unfiled tax returns, taxes associated with underreported income on filed returns, and underpaid taxes on filed returns.[10] Within the underreported income component, the IRS has further delineated specific categories of taxes, such as individual, corporate, employment, estate, and excise taxes. However, the IRS is not confident in the reliability of certain components of its tax gap estimate. Areas of uncertainty include portions of the underreported employment tax segment and the underreported corporate tax segment, because the underlying data is 15 years old or more and the IRS has low confidence in its original estimates. Thus, these figures are simply rough estimates of the tax gap problem.

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

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

[10] This definition and the associated categories have evolved over time. IRS tax gap estimates in 1979 and 1983 included unpaid income taxes owed from illegal activities such as drug dealing and prostitution. That practice was discontinued in the 1988 estimate. Reasons given for excluding are 1) the magnitude of the illegal sector is extremely difficult to estimate; and 2) the interest of the government is not to derive revenue from these activities, but to eliminate the activities altogether. Earlier tax gap figures such as those for 1965 and 1976 only included underreporting. While figures for more recent years (1992, 1995, 1998 and 2001) are more comparable, they are essentially the same estimates adjusted for the growth in the economy. Thus, comparing the figures does not show real growth in the tax gap. Lastly, comparisons among years are not done in constant dollars, so any real growth in the tax gap cannot be determined through this IRS data.

Figure 1: Tax Gap



Source: IRS Tax Gap Facts and Figures

The recently updated estimates of the tax gap released March 29, 2005, and developed for TY 2001, estimated the annual gross tax gap[11] to be between $312 and $353 billion. The net tax gap, which is the portion of this amount that will not be collected after all IRS and taxpayer actions have been completed for a given TY, was estimated to be between $257 and $298 billion.[12] To provide some perspective on the size of this estimate, if collected, these dollars could fund the two largest segments of the Department of Defense budget for 2006 – military personnel and operations and maintenance.

The largest estimated component of the tax gap is the underreporting component, which for TY 2001 was estimated to be between $250 and $292 billion. Within that component, underreporting of individual income taxes was estimated to be between $150 and $187 billion, with business income estimated to be $83 to $99 billion of that total (about 27 percent of the total gross tax gap). The second largest segment of underreporting at

[11] The amount of tax that is imposed for a given tax year but is not paid voluntarily and timely.
[12] INTERNAL REVENUE SERVICE, TAX GAP FACTS AND FIGURES 3, *available at* http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf (last visited Apr. 5, 2005).

$66 to $71 billion is the employment tax, which includes social security, medicare, and unemployment taxes. Self-employment tax, which is self-reported, is the largest component of that category at $51 to $56 billion (16 percent of the gross tax gap).

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

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

Approximately every three years from 1963 to 1988, the IRS conducted studies to measure tax compliance.[13] Estimates of the tax gap were first developed from these studies in 1973.[14] However, the program used to conduct these studies, called the Taxpayer Compliance Measurement Program (TCMP), was shelved in 1991 due to concerns about its burden on compliant taxpayers.[15] When the IRS unveiled an expanded approach to measure compliance in 1994, the Congress decided to eliminate all funding for this project because of concerns about its intrusiveness. More recently, the IRS initiated a new program to measure compliance, and its results were used to produce the recent update of the individual tax gap figures.[16]

Although better data will help the IRS identify noncompliant segments of the population, broader strategies and better research are also needed to determine what actions are most effective in addressing noncompliance. The Taxpayer Advocate's 2004 *Annual Report to Congress* effectively lays out some of the complexities involved in structuring an enforcement program to address the tax gap, and the efforts the IRS still needs to make to analyze the effectiveness of various compliance techniques.[17] Similarly, in two recent audit reports, TIGTA identified examination programs that the IRS implemented nationwide before

[13] KIM M. BLOOMQUIST ET AL., INTERNAL REVENUE SERVICE, TAX NONCOMPLIANCE IN THE UNITED STATES: MEASUREMENT AND RECENT ENFORCEMENT INITIATIVES (2004).
[14] *See* GENERAL ACCOUNTING OFFICE, *supra* note 5.
[15] The TCMP was considered by the IRS and by external stakeholders to be burdensome to taxpayers because of the intensive "line-by-line" nature of its audits. *See* KIM M. BLOOMQUIST ET AL., *supra* note 14; GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/GGD-95-59, TAX ADMINISTRATION: ESTIMATES OF THE TAX GAP FOR SERVICE PROVIDERS (1994).
[16] *See* discussion *infra* p. 11.
[17] NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE, 2004 ANNUAL REPORT TO CONGRESS (2004).

obtaining results on their possible effectiveness or before implementing an effective strategy to measure the results of the program.[18]

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

The Cash Economy: A Growing Problem

The cash economy and the resulting underreporting of income for tax purposes have been a significant portion of the tax gap for many years.[19] The cash economy, also known as the underground economy, consists of activities which may be both productive and legal, but which are deliberately concealed from public authorities for a variety of reasons, such as to avoid the payment of taxes or to avoid meeting certain standards or administrative requirements.[20] As described earlier, underreporting of individual business income and self-employment taxes on filed returns comprises nearly half of the 2001 estimated tax gap. Taking action to improve compliance in this area is critical to making strides in addressing the tax gap.

The difference in compliance rates between individual wage-earning taxpayers and those operating businesses is striking. The IRS has estimated that individuals whose wages are subject to withholding report 99 percent of their wages for tax purposes.[21] In contrast, self-employed individuals who formally operate non-farm businesses[22] are estimated to report only about 68 percent of their income for tax purposes. Even more alarming, self-employed individuals

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

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

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

[21] *See* GENERAL ACCOUNTING OFFICE, *supra* note 15; INTERNAL REVENUE SERVICE, PUB. 1415, FEDERAL TAX COMPLIANCE RESEARCH: INDIVIDUAL INCOME TAX GAP ESTIMATES FOR 1985, 1988, AND 1992, (Rev. 1996).

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

operating businesses on a cash basis[23] report just 19 percent of their income to the IRS.

Estimates indicate that the cash economy is growing.[24] A recent article in *Barron's* on the underground economy in this country estimated that the income in this segment of the population is currently about 9 percent of the gross domestic product and will soon surpass $1 trillion.[25] The article indicated that growth of this segment of the economy has been spurred by corporate downsizing, which has forced many employees to become independent contractors, and by the increasing size of the nation's population of undocumented immigrants.

An April 2002 Economic Roundtable briefing paper entitled "Workers Without Rights" explored the informal economy in Los Angeles.[26] Even using conservative estimates, the study stated that unpaid payroll and insurance benefits exceeded $1.1 billion. The briefing paper estimated the size of the informal economy to be between 9 and 29 percent of the employment in Los Angeles County. The informal economy included employment in a variety of manufacturing industries, agriculture, construction and others. Thus, the informal economy operates in many aspects of the economy and obtains a competitive advantage by paying low wages and not paying employment taxes.

Although the noncompliance rate in the cash economy is high, the percentage of examinations of self-employed taxpayers is still low. The figure below indicates that in the past 9 years, this percentage dropped from 3.60 percent in 1996 to a low of 1.55 percent in 2000. In the last 4 years, however, the percentage has risen to 2.13 percent.

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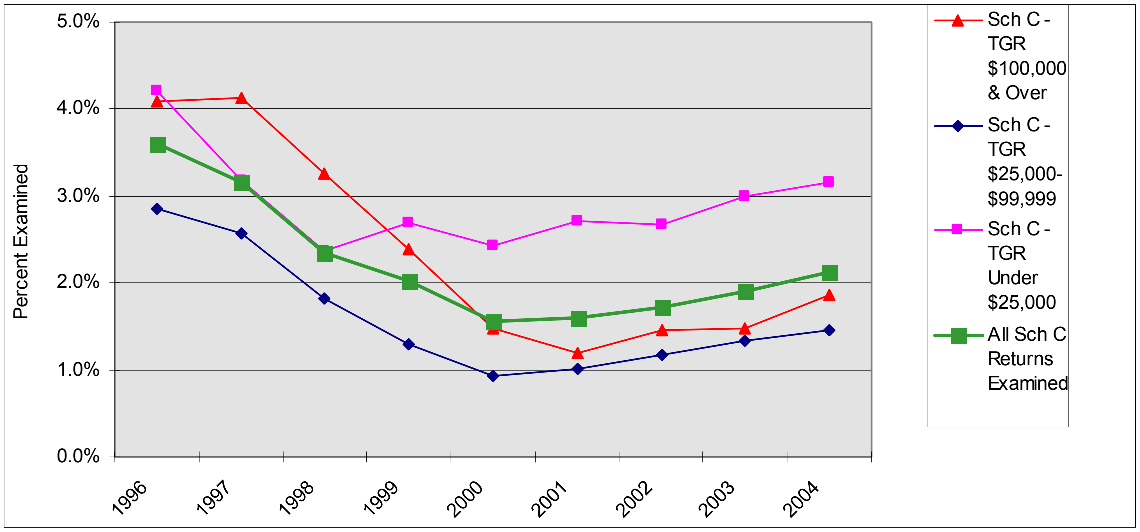
[23] These individuals provide products or services through informal arrangements which typically involve cash transactions or "off-the-books" accounting practice. This group includes child care providers, street vendors, and moonlighting professionals.

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

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

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

Figure 2. Examination Coverage of Forms 1040 With Business Income[27]



Source: TIGTA Analysis of IRS Data Book Information.

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

<u>Recommendations for Closing the Tax Gap</u>

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

- Reduce the Complexity of the Tax Code;
- Gather Better Compliance Data;
- Institute Withholding on Non-employee Compensation;
- Improve Compliance with Estimated Tax Payments;
- Establish Document Matching to Verify Business Income;
- Address Increasing Levels of Late Filed Returns;
- Increase Resources in the IRS Enforcement Functions; and,
- Address Delays in Systems Modernization.

Reduce the Complexity of the Tax Code

As the Taxpayer Advocate stated in the 2004 *Annual Report to Congress*, the most serious problem facing taxpayers and the IRS is the complexity of the Internal Revenue Code.[28] Nearly all taxpayers are now affected by these

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[27] "TGR" is Total Gross Receipts, and "Sch C" is Schedule C, the tax return schedule used by the self-employed to report a profit or loss from business.
[28] *See* NATIONAL TAXPAYER ADVOCATE, *supra* note 17.

complexities —from a single mother struggling to determine her eligibility for the Earned Income Tax Credit (EITC) to the dual-income family with four children having to recalculate their taxes to identify any Alternative Minimum Tax liability to the small business owner left wondering which schedule to use to depreciate his assets. Without meaningful tax code simplification, it is likely that the complexities of the current tax code will continue to contribute to the tax gap.

In 2001, the Joint Committee on Taxation conducted a study on the complexity of the tax law, and found that at that time, the tax code consisted of nearly 1.4 million words. There were 693 sections of the code applicable to individuals, 1,501 sections applicable to businesses, and 445 sections applicable to tax exempt organizations, employee plans, and governments. At that time, a taxpayer filing an individual income tax return (Form 1040) could be faced with a 79 line return, 144 pages of instructions, 11 schedules totaling 443 lines (including instructions), 19 separate worksheets embedded in the instructions, and the possibility of having to file numerous other forms.[29] For the 2005 tax filing season, the IRS estimates it should take, on average, over 19 hours to complete and file a 2004 Form 1040 and the associated Schedule A.

The EITC is an example of a program that is so complicated, it is difficult for both taxpayers and the IRS to consistently and accurately determine eligibility. The taxpayers eligible for this program are those who can least afford to obtain professional tax assistance to overcome this complexity. TIGTA recently completed a follow-up audit on the EITC recertification program which was designed to keep ineligible individuals from receiving the EITC until they prove their eligibility to the IRS.[30] TIGTA found that during a two-year period the IRS gave over $100 million in EITC to taxpayers who had not proven their eligibility. Conversely, during a three-year period, over $20 million was improperly denied to individuals who were entitled to these funds.

The complexities of the tax law affect the ability of the IRS to administer the nation's tax system. The IRS' efforts to provide assistance to taxpayers are hampered because of these complexities. TIGTA has performed numerous audits of the accuracy of IRS responses to taxpayer questions by visiting Taxpayer Assistance Centers (TAC) in person, calling the IRS toll-free telephone lines, and accessing the IRS internet site.

Our most recent audit of the accuracy of responses provided to tax law questions received via the toll-free telephone lines during the 2004 Filing Season found that 62 percent of the answers given were correct.[31] The IRS conducted its own tests

[29] STAFF OF THE JOINT COMMITTEE ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 (Comm. Print 2001).
[30] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-40-039, THE EARNED INCOME CREDIT RECERTIFICATION PROGRAM CONTINUES TO EXPERIENCE PROBLEMS (2005).
[31] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-40-150, ADDITIONAL EFFORT ANSWERING TAX LAW QUESTIONS WOULD IMPROVE CUSTOMER SERVICE (2004).

and found an accuracy rate of 74 percent for the same time period. Both of these figures were well below the IRS' accuracy goal of 85 percent for this service. Tax law complexity contributes to the IRS' challenges in trying to reach these accuracy goals.

The Volunteer Income Tax Assistance (VITA) Program, which assists underserved segments of low-income, elderly, disabled, and limited English proficient taxpayers, is also adversely affected by the complex tax law. In calendar year (CY) 2003, the VITA program assisted nearly 850,000 taxpayers[32] at 3,791 sites throughout the country. In 2004, TIGTA conducted a review in which auditors visited some VITA sites to have tax returns prepared.[33] All of the 35 returns prepared at the VITA sites were incorrectly prepared. If filed, those returns would have resulted in $26,007 in incorrect refunds and $4,546 in refund entitlements that would not have been received. Use of return preparation tools and adequate training are key to accurate return preparation at VITA sites. TIGTA is currently doing a follow-up review of tax return preparation at VITA sites to determine whether accuracy rates have improved.

At the other end of the economic spectrum, white collar professionals and executives have used the complexities of the tax code to devise intricate schemes to illegally shelter income from taxation. Widely publicized corporate scandals over the last several years indicate that abusive tax shelters may be more common than once thought. The IRS has increased its oversight of tax shelters with some significant success stories. The indictment and recent arrest of Walter Anderson is a reminder to all taxpayers that those in upper income brackets have the same responsibility as other taxpayers to pay what they owe.[34]

However, the complexities of the tax law make the job of pursuing abusive tax avoidance schemes even more challenging and costly. Recent IRS statistics for revenue agents indicate that time spent per tax return on examinations has increased in the last 2 years.[35] For example, in fiscal year (FY) 2004, hours spent per return on examinations were up 23 percent for individual tax returns and 19 percent for corporate tax returns over FY 2003 figures. The increase in time spent on examinations could be partially attributed to the types of cases that were being worked. The Small Business/Self-Employed Division has designated several categories as high-priority, including:

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[32] This figure includes nonmilitary and military VITA-prepared tax returns. For TY 2002, the IRS was unable to distinguish between returns prepared by the military and nonmilitary VITA sites. Nonmilitary sites account for 92 percent of all VITA sites.

[33] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-40-154, IMPROVEMENTS ARE NEEDED TO ENSURE TAX RETURNS ARE PREPARED CORRECTLY AT INTERNAL REVENUE SERVICE VOLUNTEER INCOME TAX ASSISTANCE SITES (2004).

[34] In late February, Walter Anderson was arrested for corruptly obstructing, impeding, or impairing the due administration of the Internal Revenue laws, tax evasion, and fraud in the first degree for failing to report hundreds of millions of dollars in income for tax purposes.

[35] TIGTA analysis of IRS Data Book Information.

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

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

Various proposals have been made to dramatically alter America's tax system. Others have made recommendations for less sweeping but more targeted changes. As a first step in reforming the code, the President has created a bipartisan panel to advise the Secretary of the Treasury on options to reform the tax code. Whatever proposal is chosen, simplifying the tax code could have a significant impact on reducing the tax gap.

Gather Better Compliance Data

The IRS has initiated a new program, the National Research Program (NRP), to measure taxpayers' voluntary compliance, to better approximate the tax gap, and to develop updated formulas to select noncompliant returns for examination. The first phase of this program addresses reporting compliance for individual taxpayers, and data from this phase were used to produce the recently updated estimates of this portion of the tax gap. These initial findings should enable the IRS to develop and implement strategies to address areas of noncompliance among individual taxpayers.

The next phase of the NRP has begun and it focuses on business taxpayers. It is critical for the IRS to efficiently complete these studies so its limited enforcement resources can be focused on the most serious areas of noncompliance.[36]

Institute Withholding on Non-employee Compensation

As stated earlier, the segment of the tax gap attributable to underreporting among individuals with business income each year is over $130 billion, or over 40 percent of the total tax gap. Over 20 years ago, GAO recommended that the Congress consider requiring withholding and improving information returns reporting for independent contractors. More recently, TIGTA recommended that the IRS initiate a proposal for a legislative change to mandate withholding on non-employee compensation payments, such as those provided to independent

[36] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION., REF. NO. 2004-30-044, ADDITIONAL EFFORTS COULD FURTHER IMPROVE THE EXECUTION OF THE NATIONAL RESEARCH PROGRAM (2004).

contractors.[37] TIGTA maintains that implementing a provision in this area could reduce the tax gap by billions of dollars. The IRS has agreed to consider such a proposal. The Taxpayer Advocate's 2003 *Annual Report to Congress* also made this recommendation.[38]

In a recent Joint Committee on Taxation report, the proposal is made to implement withholding on payments from government entities.[39] The proposal recommends withholding three percent of payments to businesses and individuals (other than employees) providing goods and services to government entities. TIGTA agrees that this proposal may be a good first step as it provides an opportunity to test the feasibility and burden associated with such withholding.

In addition to implementing withholding on non-employee compensation, other actions should be taken to improve compliance among independent contractors.[40] For example, improvement is needed to address inaccurate reporting of Taxpayer Identification Numbers (TIN) for independent contractors. For TYs 1995 through 1998, the IRS received about 9.6 million statements for Recipients of Miscellaneous Income (Forms 1099-MISC), reporting approximately $204 billion in non-employee compensation that either did not contain a TIN or had a TIN that did not match IRS records. This problem could be addressed with legislation mandating that the payer and payee verify the TIN at the beginning of their relationship. Additionally, withholding could be mandated for independent contractors who fail to furnish a TIN. Implementing mandated withholding for this segment of independent contractors would result in an estimated $2.2 billion in increased revenue to the IRS each year.

Improve Compliance with Estimated Tax Payments

Because individual taxpayers with businesses are not subject to withholding, estimated tax is the method used to pay taxes on non-wage income on a quarterly basis.[41] About 12 million taxpayers made estimated tax payments totaling $183 billion for TY 2001. However, there are significant levels of taxpayer noncompliance with estimated tax payment requirements. For each tax year from 1995 through 2000, between 5.7 million and 6.8 million individual taxpayers were assessed penalties for making insufficient or late estimated tax

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[37] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-30-040, WHILE PROGRESS TOWARD EARLIER INTERVENTION WITH DELINQUENT TAXPAYERS HAS BEEN MADE, ACTION IS NEEDED TO PREVENT NONCOMPLIANCE WITH ESTIMATED TAX PAYMENT REQUIREMENTS (2004); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2001-30-132, SIGNIFICANT TAX REVENUE MAY BE LOST DUE TO INACCURATE REPORTING OF TAXPAYER IDENTIFICATION NUMBERS FOR INDEPENDENT CONTRACTORS (2001).
[38] NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE, 2003 ANNUAL REPORT TO CONGRESS (2003).
[39] STAFF OF THE JOINT COMMITTEE ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES (Comm. Print 2005).
[40] *See* TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, *supra* note 37.
[41] *See* TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, *supra* note 37.

payments. Many of these taxpayers also filed tax returns without paying the associated taxes, and this resulted in the IRS having to take costly collection actions.

To address estimated tax payment noncompliance, TIGTA recommended the IRS explore legislative proposals to require estimated tax payments to be made on a monthly basis. Additionally, the IRS should change how the estimated tax penalty rate is determined to ensure it serves as a more effective deterrent to noncompliance, and should issue a mid-year reminder notice to certain taxpayers. Implementing these recommendations would result in increased compliance, reduced penalty and interest assessments for certain taxpayers, and reduced collection costs to the IRS. The IRS disagreed with our recommendations, indicating that monthly payments would increase the burden on taxpayers,[42] and that it had previously made a different proposal to change the estimated tax penalty rate.[43]

Establish Document Matching to Verify Business Income

TIGTA has also identified improvements that should be made to improve compliance in business tax filing.[44] The GAO reported that more than 60 percent of U.S.-controlled corporations and more than 70 percent of foreign-controlled corporations did not report tax liabilities from 1996 through 2000.[45] Although individual wage earners who receive a Wage and Tax Statement (Form W-2) have their wages verified through a matching program, a similar comprehensive matching program for business documents received by the IRS does not exist. TIGTA recommended that the IRS evaluate all types of business documents it receives to determine if this information can be used to improve business compliance. Additionally, based on this evaluation, the IRS should consider the feasibility of legislative changes to require that additional information returns be issued for corporations so that the IRS has more complete information for these businesses.

TIGTA has also reported on issues related to partnerships and foreign partners, and has recommended automating a system to crosscheck withholding claims

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[42] TIGTA considered the burden issue, but indicated that monthly payment intervals are an established and common business practice in the private sector. Most Americans are already used to making monthly payments on their home mortgages, rent, car loans, credit cards, and utilities.
[43] The IRS developed a legislative proposal recommending the Congress raise the minimum underpayment amount on which penalties are assessed for failure to make estimated tax payments. It also proposed to change the rate at which the estimated penalty is determined.
[44] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2002-30-185, THE IRS SHOULD EVALUATE THE FEASIBILITY OF USING AVAILABLE DOCUMENTS TO VERIFY INFORMATION REPORTED ON BUSINESS TAX RETURNS (2002).
[45] GENERAL ACCOUNTING OFFICE, PUB. NO. GAO-04-358, TAX ADMINISTRATION: COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN- AND U.S.-CONTROLLED CORPORATIONS, 1996-2000 (2004).

against available credits prior to issuing refunds to foreign partners.[46] Implementing a comprehensive matching program to identify noncompliance among businesses would be difficult and could require some legislative changes, but it could identify significant pockets of noncompliance among business taxpayers.

Address Increasing Levels of Late Filed Returns

Taxpayer payment compliance means that the amounts owed are paid on time. However, for decades the IRS has allowed taxpayers with extended return filing due dates to send in late payments and pay only interest and small failure to pay penalties. Obtaining an extension of time to file a tax return does not extend the due date for tax payments, and failure to pay penalties are typically assessed when payments are made late, even if the taxpayer has received an extension.

In 1993, IRS management eliminated the requirement to pay all taxes by the payment due date in order to qualify for an extension of time to file. Once an extension has been granted, the taxpayer is exempt from a 5 percent per month Delinquency Penalty[47] for the period of the extension. TIGTA evaluated the impact of these rules on individual and corporate taxpayers and found that 88 percent of untimely tax payments for returns filed after April 15 were attributable to extended due date taxpayers.[48] Corporations are required to pay estimates of their unpaid taxes to be granted extensions. However, TIGTA found corporate estimates to be highly flawed; in CY 1999 alone, approximately 168,000 corporations received an extension, yet failed to pay $1.8 billion in taxes by the normal tax return date.

TIGTA projected that the tax gap from extension-related individual income tax underpayments would amount to approximately $46.3 billion in CY 2008, of which approximately $29.8 billion would not be paid until after the end of FY 2008. Due to the more complex nature of corporate taxes, similar figures were not available for corporations, although TIGTA estimated that by TY 2008, approximately $768 million in additional corporate taxes would be timely paid if TIGTA's recommendations were adopted. The IRS is currently studying TIGTA's recommendations.

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[46] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2001-30-084, STRONGER ACTIONS ARE NEEDED TO ENSURE PARTNERSHIPS WITHHOLD AND PAY MILLIONS OF DOLLARS IN TAXES ON CERTAIN INCOME OF FOREIGN PARTNERS (2001).

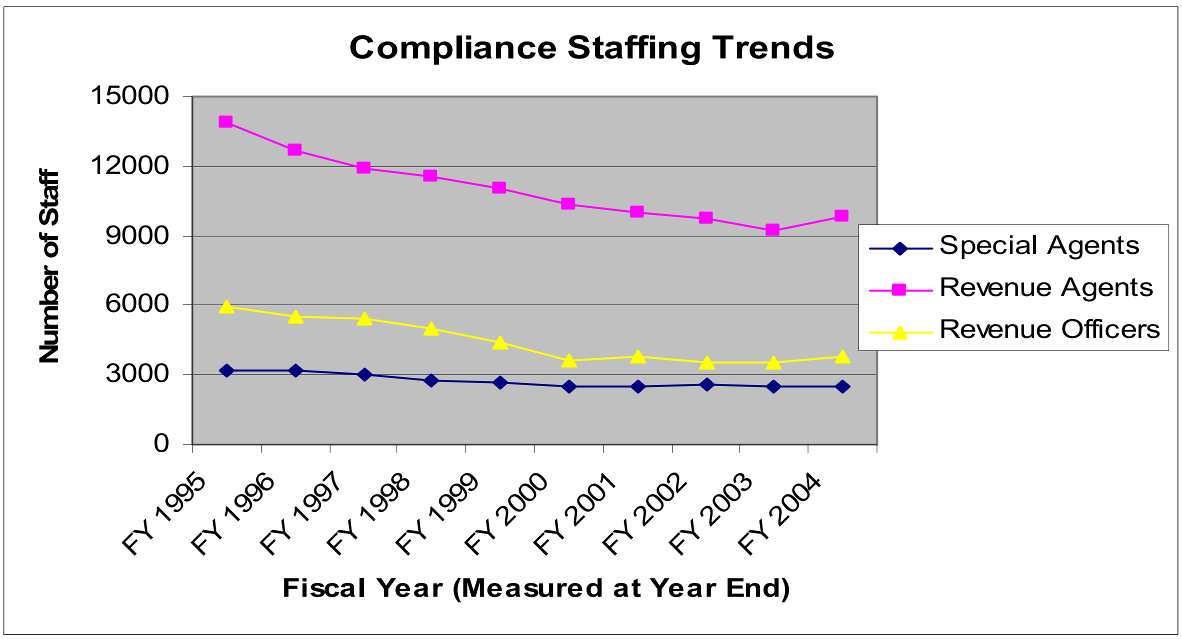
[47] The Delinquency Penalty is also known as the Failure-to-File Penalty, although it only applies to taxpayers who both file late and fail to pay all taxes by the tax payment deadline.

[48] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2003-30-132, THE REGULATIONS FOR GRANTING EXTENSIONS OF TIME TO FILE ARE DELAYING THE RECEIPT OF BILLIONS OF TAX DOLLARS AND CREATING SUBSTANTIAL BURDEN FOR COMPLIANT TAXPAYERS (2003) and TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-30-106, CHANGES TO THE REGULATIONS FOR GRANTING EXTENSIONS OF TIME TO FILE CORPORATE RETURNS ARE NEEDED TO ALLEVIATE SIGNIFICANT PROBLEMS WITH ADMINISTERING THE TAX LAWS (2004).

Increase Resources in the IRS Enforcement Functions

Staffing in the IRS enforcement areas has decreased significantly in the last few years.[49] However, in 2004, the IRS received additional funding and was able to increase its enforcement staffing slightly over the prior year. In the Examination function, the number of Revenue Agents decreased from 13,857 in FY 1995 to 9,787 in FY 2004. In the Collection function, the number of Revenue Officers decreased from 5,908 in FY 1995 to 3,789 in FY 2004. These decreases in staffing occurred during a period in which the number of tax returns filed increased over 10 percent.

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



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

One effect of the lack of resources in the Collection function is that the Queue,[50] has increased significantly since FY 1996. In FY 1996, there were 317,865 balance due accounts worth $2.96 billion in the Queue. In FY 2004, these figures had increased to 623,477 balance due accounts worth $21 billion. Additionally, the number of unfiled tax return accounts in the Queue increased from 326,118 in FY 1996 to 838,090 in FY 2004.

[49] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-30-055,TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2004 (2005).
[50] An automated holding file for unassigned inventory of lower priority delinquent cases that the Collection function does not have enough resources to immediately assign for contact.

The number of balance due accounts "shelved", or removed from the Queue altogether because of lower priority, has also increased significantly. In FY 1996, less than 8,000 of these balance due accounts were shelved, but in FY 2004, over a million of these accounts were removed from inventory. From FY 2001 to FY 2004, approximately 5.4 million accounts with balance due amounts totaling more than $22.9 billion were removed from Collection function inventory and shelved. Additionally, in FY 2004 alone, over 2 million accounts with unfiled returns were shelved.

If increased funds for enforcement are provided to the IRS in upcoming budgets, the resource issues in the enforcement functions will be addressed to some degree. In addition, use of contractors should allow the IRS to collect more outstanding taxes. The IRS will have to be vigilant in overseeing these contractors to ensure that abuses do not occur. Past experiences with lockbox thefts and insufficient contractor oversight provide valuable lessons to reduce the likelihood of similar issues occurring when contracting out collection of tax debt.[51]

Address Delays in Systems Modernization

In 1993, GAO stated:

> Dramatic improvements in IRS' ability to collect delinquent taxes and reduce the tax gap, for example, will only come about, in our opinion, through dramatic changes in the way IRS does business. Central to such change will be the capability of IRS employees to obtain on-line access to accurate, up-to-date information whenever they need it—the ultimate goal of TSM [Tax Systems Modernization].[52]

Modernizing IRS computer systems and providing more tools to address compliance are still key to giving employees the ability to effectively and efficiently address the tax gap.

Although cost increases and schedule delays have plagued the new modernization effort, now called Business Systems Modernization, the IRS has

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

[52] *Hearings on the Status of Tax Systems Modernization, Tax Delinquencies, and the Tax Gap Before the Subcomm. on Treasury, Postal Service and General Government of the House Comm. on Appropriations*, 103rd Cong. 16 (1993) (statement of Jennie S. Stathis, General Accounting Office).

begun to implement some of the initial phases of key systems.[53] One such system, the Customer Account Data Engine (CADE),[54] when completed will replace the IRS' current Master File[55] and is a cornerstone in the modernization effort. In 2004, the first phase of CADE became operational and began processing tax returns for a small segment of the population.

One of the modernization systems that was proposed to address taxpayer compliance was the Filing and Payment Compliance (F&PC) project.[56] During FY 2005 and 2006, the IRS plans the first two subreleases of the F&PC project, which will provide the IRS with the ability to automatically provide limited tax information from its systems to a small number of private debt collection agencies.[57] A third subrelease, scheduled for FY 2007, will be required to provide full functionality to the private debt collection segment of the F&PC project.

Balance Between Enforcement, Taxpayer Rights, and Customer Service

Reaching the appropriate balance among enforcement, taxpayer rights, and customer service is a key issue to the tax gap discussion, but it is not easy to achieve. The IRS has been criticized for its swings between focusing on enforcement to the detriment of customer service, or vice versa. Commissioner Everson's guiding principle for the IRS, *Service + Enforcement = Compliance,* relates his goal for striking the right balance necessary to achieve compliance and address the tax gap.[58] TIGTA agrees that enhancing enforcement while improving customer service is the proper direction for the IRS.

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[53] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-20-107, ANNUAL ASSESSMENT OF THE BUSINESS SYSTEMS MODERNIZATION PROGRAM (2004).

[54] The CADE is the foundation for managing taxpayer accounts in the IRS' modernization plan. When completed, it will consist of databases and related applications that will replace the IRS' existing Master File processing systems and will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer tax account and return data. The CADE databases and related applications will also enable the development of subsequent modernized systems that will improve customer service and compliance and allow the on-line posting and updating of taxpayer account and return data. The portion of the CADE related to individual tax accounts will be incrementally deployed in five releases, each related to a specific taxpayer segment, over several years. At the conclusion of Release 5, the CADE will have replaced the Individual Master File, and the IRS will conduct business much differently than it does today.

[55] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

[56] The F&PC was intended to provide support for detecting, scoring, and working nonfiler cases (filing compliance) and delinquency cases (payment compliance). The IRS completed the planning phases for the Filing and Payment Compliance project in 2003, but suspended the project due to concerns with costs. In FY 2004, the portion of this project designed to support private debt collection was restarted.

[57] IRS Taxpayer Relationship Management Executive Steering Committee meetings for January and February 2005.

[58] INTERNAL REVENUE SERVICE, PUB. 3744, IRS STRATEGIC PLAN 2005-2009 (Rev. 2004).

To ensure taxpayer rights are protected, each year TIGTA performs several audits to evaluate the impact of IRS' enforcement actions and related activities on taxpayers, in accordance with the IRS Restructuring and Reform Act of 1998 (RRA 98).[59] Generally, the IRS is in compliance with the provisions of RRA 98 that TIGTA has reviewed. For example, the law's restrictions on the use of enforcement statistics to evaluate employees continue to be followed, and IRS employees typically follow the legal requirements on liens and levies.[60] Our audit this past year on compliance with seizure provisions did find an increase in errors, such as required forms not being sent to taxpayers or expenses of the sale not properly charged to taxpayers' account, but these discrepancies did not result in any adverse impact on taxpayers.[61]

Since the passage of RRA 98, the IRS' focus on customer service has led to many improvements. Individual taxpayer satisfaction rates with IRS have increased since the law's passage, rising from 51 to 64 percent between 1999 and 2004.[62] The ability of taxpayers to contact the IRS via telephone has improved, and customer service at the TACs has shown progress.[63] For example, from January 2002 to April 2004, the TAC tax law accuracy rate increased from 54 to 67 percent.

The IRS internet site, www.IRS.gov, is an excellent source for forms, publications, and other guidance, and taxpayers visited the site over 139 million times last year.[64] The site also received an award for being the nation's most reliable government internet site. Electronic filing of tax returns is continuing to

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

[60] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-40-066, FISCAL YEAR 2004 STATUTORY AUDIT OF COMPLIANCE WITH LEGAL GUIDELINES RESTRICTING THE USE OF RECORDS OF TAX ENFORCEMENT RESULTS, (2004); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-30-086, FISCAL YEAR 2004 STATUTORY REVIEW OF COMPLIANCE WITH LIEN DUE PROCESS PROCEDURES (2004); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-30-094, ADDITIONAL EFFORTS ARE NEEDED TO ENSURE TAXPAYER RIGHTS ARE PROTECTED WHEN MANUAL LEVIES ARE ISSUED (2004).

[61] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-30-149, LEGAL AND INTERNAL GUIDELINES WERE NOT ALWAYS FOLLOWED WHEN CONDUCTING SEIZURES OF TAXPAYERS' PROPERTY (2004).

[62] American Customer Satisfaction Index, "ACSI Overall Federal Government Scores with Historic Scores of Agencies Measured 1999- 2004", December 14, 2004.

[63] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2004-30-038, ACCESS TO THE TOLL-FREE TELEPHONE SYSTEM WAS SIGNIFICANTLY IMPROVED IN 2003, BUT ADDITIONAL ENHANCEMENTS ARE NEEDED (2004); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO. 2005-40-021, CUSTOMER SERVICE AT THE TAXPAYER ASSISTANCE CENTERS IS IMPROVING BUT IS STILL NOT MEETING EXPECTATIONS (2004).

[64] INTERNAL REVENUE SERVICE, *IRS.gov Cited As Most Reliable Government Web Site*, IR-2004-131, *available* at http://www.irs.gov/newsroom/article/0,,id=130492,00.html (last visited Apr. 7, 2005).

grow, and the ability to check the status of tax refunds online has been a successful IRS project that is helpful to taxpayers.[65]

While the IRS has made progress in the customer service area, enforcement actions have dropped dramatically since the passage of RRA 98. Although the numbers have begun to increase, liens, levies, and seizures against noncompliant taxpayers are all down significantly from their totals in the 1990s. In 1997, for example, the IRS issued over 3.5 million levies compared to just over 2 million in 2004. The drop in seizures is even more striking — dropping from over 10,000 in 1997, to just 440 in 2004.[66]

One contributing factor to the decline in enforcement actions was section 1203 of RRA 98.[67] That section, commonly known as the "ten deadly sins," detailed specific actions that, if taken by IRS employees, could result in removal from the IRS. Additionally, section 1204 prohibits the use of enforcement statistics to set goals or evaluate personnel at any level within the IRS. These two sections have caused a great deal of hesitation and concern among employees and managers contemplating enforcement actions, as well as significant confusion about the appropriateness of using time or efficiency measures to evaluate IRS employee performance.[68] The reduction in enforcement actions is likely due, in part, to these provisions.

However, recent statistics measuring compliance efforts and results show some positive changes in FY 2004.[69] For example, the amount of enforcement revenue increased by 15 percent in FY 2004, to $43.1 billion, and this amount (not adjusted for inflation) is 14 percent higher than the FY 1996 level. The increase in FY 2004 is due to a 33 percent increase in the amount collected on business accounts, which was the top priority for the Collection function. Examinations of individual tax returns increased in FY 2004 from the previous year. In comparison, examinations of corporate returns decreased 23 percent from FY 2003, but examinations of corporate tax returns with assets of $10 million or more increased 34 percent in FY 2004.

TIGTA maintains that the IRS is moving in the right direction to enhance its focus on enforcement of the tax laws. As I stated earlier, however, it is critical for the IRS to have timely, accurate data to make resource allocation decisions to strike the appropriate balance between customer service and enforcement.

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[65] INTERNAL REVENUE SERVICE, *Free File Tops Last Year's Total*, IR-2005-36, *available at*, http://www.irs.gov/newsroom/article/0,,id=137055,00.html (last visited Apr. 7, 2005).
[66] TIGTA Analysis of IRS Data Book.
[67] *2001 Tax Return Filing Season*: *Hearing Before the House Ways and Means Subcomm. on Oversight*, 107th Cong. (2001) (statement of Charles O. Rossotti, Commissioner of Internal Revenue).
[68] *2001 Tax Return Filing Season*, supra note 67.
[69] TIGTA analysis of IRS' Enforcement Revenue Information System data, and IRS Data Book Information.

I am concerned that the IRS may take a step backwards on customer service if it follows through with its proposal to close many TACs. The TACs are walk-in sites where taxpayers can receive answers to both account questions and tax law questions as well as receive assistance preparing their tax returns. The IRS is considering closing nearly 20 percent of its approximately 400 TACs nationwide.

As part of an ongoing audit,[70] we are reviewing the methodology used by the IRS to determine which TACs to close. At this point, I am skeptical that the IRS has adequate data to assess the impact that closing these centers will have on customer service. I am also concerned that the IRS has insufficient data to draw conclusions on the likelihood that taxpayers, who have used these centers in the past, will be able to use other methods of seeking help, such as the internet or telephone. I strongly recommend that the IRS further research these issues before closing selected TACs.

In addition, the IRS has made a decision to cancel the Telefile project. In 2003, TIGTA recommended that the IRS explore other opportunities to expand – not cancel – the Telefile program.[71] We continue to believe the Telefile program services millions of taxpayers and is worth pursuing today. However, the IRS has decided to discontinue the Telefile program after the 2005 filing season due to high costs, low demand, and increased availability of e-filing options. If the IRS follows through with its decision to discontinue the Telefile program, it should at least develop a strategy to accommodate Telefilers who are unable to e-file.

The IRS must exercise great care not to emphasize enforcement at the expense of taxpayer rights and customer service. I believe that steps to reduce the current level of customer service should be taken only with the utmost thought and consideration of their impact, and only with all the necessary data to support these actions. Customer service goals must be met and even improved upon, or people will lose confidence in the IRS' ability to meet part of its mission of providing America's taxpayers quality service by helping them understand and meet their tax responsibilities.

Mr. Chairman and members of the committee, I appreciate the opportunity to share my views on the tax gap, and the work TIGTA has done in this area. I would be happy to answer any question you may have at the appropriate time.

[70] Draft audit report has not yet been issued.
[71] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REF. NO, 2003-40-092, OPPORTUNITIES EXIST TO EXPAND THE TELEFILE PROGRAM (2003).