

**Written Statement of
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Before the

Subcommittee on Taxation and IRS Oversight

**Committee on Finance
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Hearing on

The Tax Gap

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Mr. Chairman, Senator Jeffords, and distinguished Members of the Subcommittee:

Thank you for inviting me to testify today regarding the causes of the tax gap and possible legislative and administrative solutions.¹

At the outset, let me suggest that the ultimate question we should be focused on is not “How can we reduce the tax gap?” but rather “How can we increase voluntary compliance?” Voluntary compliance – as opposed to enforced compliance – must be our goal for several overriding reasons.

- First, enforcement is best suited for circumstances in which taxpayers are willfully seeking to evade their tax obligations. As I will describe in more detail below, the limited data available suggests that a high percentage of taxpayer errors – probably a significant majority – are attributable to inadvertence rather than deliberate cheating.
- Second, it is far preferable from a public policy standpoint when taxpayers pay voluntarily rather than pursuant to enforcement action. We should strive to make sure taxpayers understand how the tax dollars they pay are used to protect and benefit them, and we should make compliance as easy as possible.
- Third, the IRS lacks the resources to do much more through enforcement. The examination rate is currently less than one percent, and the majority of those examinations are limited-scope examinations conducted by mail.² Even if we were somehow able to double the examination rate, more than 98 percent of taxpayers would not be examined each year. So we need to focus on maximizing voluntary compliance by simplifying the tax laws and improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear abuses and send a message to all taxpayers that noncompliance has consequences.
- Fourth, we need to identify ways to slowly transform attitudes toward the tax system to create new norms of behavior – namely, tax compliance. Enforcement is only moderately successful at that, and it is generally not very successful with taxpayers who erred inadvertently. In fact, harsh enforcement measures against inadvertently noncompliant taxpayers may increase distrust of the IRS and create deliberate noncompliance.

¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. The statute establishing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

² 2005 IRS Data Book, Table 10, at 19. The IRS also proposes adjustments using math-error authority and its automated under-reporter (AUR) and automated substitute for return (ASFR) programs.

I. The Tax Gap Is A Significant Problem From The Perspective Of Both Federal Revenue And Taxpayer Equity.

The Federal tax gap has been receiving increasing attention over the last few years. It deserves this increased attention and more. The recent IRS National Research Program study estimates the 2001 “gross tax gap” – the difference between the amount of tax imposed by law and the amount of tax paid voluntarily and timely – at \$345 billion. It estimates the net tax gap – the difference between the amount of tax imposed by law and the amount of tax paid after taking into account late payments and enforced collection – at \$290 billion. In fact, the IRS acknowledges the actual tax gap is larger. For example, the study did not even venture a guess as to the amount of illegal source income that goes unreported and on which taxes are not paid.

If the IRS were able to collect all taxes due under current law, we would not have a budget deficit. If the IRS were able to collect half the taxes that currently go uncollected, we could repeal the Alternative Minimum Tax. Of course, it will never be possible to eliminate the tax gap entirely, but even modest improvements have significant revenue implications.

In addition to these larger issues, I want to emphasize that the tax gap has real victims. Individuals and businesses that fail to pay their taxes impose a significant burden on taxpayers who comply with their tax obligations. If we divide the 2001 net tax gap estimate of \$290 billion by the roughly 130 million individual tax returns received, we can see that each tax filer in 2001 paid, on average, a “surtax” of more than \$2,000 to subsidize noncompliance by others.

As the National Taxpayer Advocate – the statutorily designated advocate for *all* taxpayers as well as specific taxpayers – I am concerned about the economic and social costs that this noncompliance imposes. In my 2003 Annual Report to Congress, I identified the tax gap, after the AMT, as the most serious problem facing taxpayers. I have continued to address the tax gap in my more recent reports to Congress, and I have testified before Senate committees on the subject on four previous occasions.³

II. Reasons for Noncompliance Vary Among Taxpayers and Proposals to Increase Compliance Should Be Devised Accordingly: “One Size Fits All” Won’t Work.

To arrive at an optimal allocation of resources to close the tax gap, the IRS needs to do a better job of understanding the reasons why the tax gap exists. As I will describe in more detail below, I am concerned that the IRS has made a decision, without adequate basis, to emphasize enforcement over improved taxpayer service.

³ The National Taxpayer Advocate has testified at the following Senate hearings focused on the federal tax gap: Senate Budget Committee (February 15, 2006); Senate Homeland Security and Governmental Affairs’ Subcommittee on Federal Financial Management, Government Information, and International Security (Oct. 26, 2005) (written statement only); Senate Finance Committee (April 14, 2005); Senate Finance Committee (July 21, 2004).

I also believe that there are limits to what the IRS can do on its own. Any improvements IRS is able to make in collecting tax revenue will be limited unless Congress simplifies the tax code and increases third-party information reporting or withholding to cover a wider array of financial transactions.

A. Types Of Noncompliance Vary.

At the risk of oversimplifying matters, let me suggest that we consider 3 types of taxpayers: (1) taxpayers who will go to great lengths to comply with whatever requirements exist; (2) taxpayers who view taxes as one of many burdens they face in everyday life and who will comply if doing so is straightforward and not time-consuming; and (3) taxpayers who willfully seek to evade their tax obligations.⁴

For each type of taxpayer, what is the reason for noncompliance and what is the optimal government response?

- For taxpayers who generally will go to great lengths to comply, the likely source of noncompliance is the complexity of the tax code. Thus, our approach should be to emphasize simpler laws and better explanations.
- For taxpayers who will comply if doing so is easy enough, our main emphasis should also be simpler laws and procedures, and better outreach and education. Here, though, we might also want to incorporate gentle enforcement action in our approach to try to persuade taxpayers that paying taxes must be a higher priority. In doing so, the IRS should incorporate taxpayer service *within* its enforcement actions. That is, at the same time that the IRS conducts audits or seeks to collect unpaid tax liabilities, the IRS should be courteous and should focus on trying to teach taxpayers how to avoid getting into trouble in the future. The IRS also must be careful to avoid creating noncompliance by imposing unrealistic procedural burdens on taxpayers who are trying to comply.
- For taxpayers who willfully seek to avoid paying taxes, enforcement is required – although even for these taxpayers, I think IRS employees generally should focus on trying to induce the taxpayers to comply prospectively.

⁴ Analysis has been conducted on types of noncompliance that is more detailed and subdivides taxpayers into narrower categories. See Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003).

B. A Substantial Amount of Misreporting – Probably the Majority of All Misreporting Errors – Is Attributable to Inadvertent Error Rather Than Intentional Noncompliance.

What percentage of taxpayers fall into each of the three categories I just described? It is impossible to know with precision. But I will briefly describe two sources of information that lead me to believe the majority of taxpayer errors are attributable to inadvertent error rather than intentional noncompliance. And this conclusion implies that the second category of taxpayer I described – the taxpayer who is not especially sophisticated and will try to comply if doing so is not overly burdensome – is where we should be directing most of our attention.

When IRS auditors conducted approximately 46,000 audits of individual taxpayers for purposes of the National Research Program, the auditors were asked, for each issue they identified, to characterize the reason for noncompliance. As shown in the following chart, the results were striking:

Reason Category	Total Issues	Percent of All Issues	Percent of All Issues Excl No Change
Inadvertent/Mistake	164,780	31%	67%
Automatic/Computational	66,907	12%	27%
Deliberate/Intentional	7,542	1%	3%
No Show/Audit Recon/SFR	4,962	1%	2%
No Change	289,096	54%	N/A
EITC Adjustment	1,401	0%	1%
Classification Issue	13	0%	0%
No Reason Code Entered	1,784	0%	1%
All Issues	536,485	100%	100%

Among issues that IRS auditors examined that resulted in a change in tax liability, the auditors listed 67 percent as inadvertent mistakes, 27 percent as computational errors or errors that flowed automatically, and only 3 percent of errors as intentional.⁵

A recent study of capital gains misreporting conducted by the Government Accountability Office also makes the case that a substantial percentage of noncompliance is inadvertent. The study concluded that 33 percent of taxpayers who misreported their income from securities transactions reported more capital gains than they actually realized.⁶ Taxpayers who over-report their income (and thus generally pay more taxes than they owe) clearly are not trying to cheat. Where misreporting is inadvertent, from a statistical standpoint, one would expect that 50 percent of errors would be on the high side and 50 percent of errors would be on the low side. Thus, GAO's finding that 33 percent of all taxpayer errors were on the high side (and thus clearly inadvertent) implies that an equal percentage of errors on the low side were inadvertent – or, put differently, that 66 percent of all errors in capital gains misreporting were inadvertent and only 34 percent were intentional.

One might argue that inadvertent errors should not be considered in discussing the tax gap because inadvertent errors should theoretically offset each other in their impact on revenue, leaving intentional errors alone as the source of the tax gap. I would fundamentally disagree with such an assessment for at least three reasons. First, the mission of the IRS is to collect the *proper* amount of tax due – not to collect as much as it can get away with.⁷ The IRS therefore has an equal duty to address errors of overpayment and errors of underpayment. If the IRS is perceived as lacking revenue neutrality in carrying out its mission to collect the proper amount of tax due, the negative impact on the public's perception of the fairness of government would be hard to overstate.

Second, I do not believe that benign noncompliance is revenue neutral. For example, considerable noncompliance involves taxpayers who do not file any returns at all – not primarily because they are trying to cheat but because they find the requirements

⁵ The precision of these results may be open to question, but even accounting for a significant margin of error, the designation by IRS's own auditors of only 3 percent of identified misreporting issues as intentional raises fundamental questions about the wisdom of the IRS's current objective of ramping up enforcement activities more than outreach and education. In the absence of contrary data, these data at a minimum should persuade IRS to conduct significant new studies on the causes of noncompliance. Largely in response to the Administration's budget request, the Senate Appropriations Committee last week recommended an IRS budget for FY 2007 that includes \$4.8 billion for enforcement and \$2.1 billion for taxpayer service. If the percentage of taxpayer errors resulting from intentional noncompliance is anything close to 3 percent, the balance between enforcement and taxpayer service should be fundamentally reevaluated in future years.

⁶ Government Accountability Office, Ref. No. GAO-06-603, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed* at 12 (June 2006).

⁷ The official IRS mission statement commits the IRS to "[p]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." See IRS News Release IR-98-59 (Sept. 24, 1998).

difficult to understand and are trying to avoid the burden. This may be particularly true for relatively low income taxpayers, taxpayers who speak English as a second language, and small business taxpayers.

Third, the large number of inadvertent errors underscores the need to go beyond classifying taxpayers simplistically as “honest” or “dishonest” and to develop solutions designed to improve compliance among a broader range of taxpayers through an approach that includes components of both taxpayer service and enforcement.

III. The IRS Can Do More To Improve Compliance Under Existing Laws.

A. The IRS Should Conduct More and Better Research On How To Get the Most Impact from Each Dollar Spent.

The IRS needs better research to determine the most effective use of its resources after taking into account both the direct and indirect effects of its activities on tax revenue.⁸ In most cases, the indirect effects are probably greater than the direct effects. Assume, for example, that the IRS increases the rate at which it audits a cash-based industry like construction and conducts the audits effectively so that it discovers all unreported income. The indirect revenue gains resulting from these audits would probably exceed the direct gains by a large margin as word spreads throughout the industry that cash income is actually subject to tax and each industry participant realizes that the IRS is examining taxpayers just like him or her. IRS researchers have estimated that the indirect effect of an average examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment.⁹

However, not all audits have the same effect on compliance. A dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing corporate tax shelters. A dollar spent on an ineffective audit may actually have a negative effect on compliance if it teaches taxpayers that they will not be caught even if audited. On the other hand, a dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving the Electronic Funds Transfer Payment System (discussed below), and answering tax law questions, has a positive indirect effect on compliance.¹⁰

⁸ See generally Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005).

⁹ Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986*, 43 Nat. Tax J. 395, 396, 405 (1990).

¹⁰ In 1996, IRS researchers estimated that every dollar the IRS spent on return preparation generated \$396 of additional tax revenue. See Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996).

The IRS does not have current research to show where its next dollar is best spent. More generally, we do not even know whether the next dollar is better spent on enforcement or on taxpayer service.¹¹ In the absence of better research, decisions about how to allocate IRS resources are being based largely on hunches and slightly educated guesses.¹²

B. It Shouldn't Be a Question of "Service or Enforcement": The IRS Should Integrate Taxpayer Service within Its Enforcement Activities.

Particularly in light of its limited resources, it is critical that the IRS focus its enforcement activities not merely on collecting taxes that were not paid in the past but on trying to bring taxpayers into compliance prospectively. At present, I am concerned that the IRS is approaching its taxpayer service and enforcement initiatives on almost entirely separate tracks. That is, in the IRS today, enforcement employees work on enforcement initiatives, and taxpayer service employees work on taxpayer service initiatives, and never the twain shall meet. This "stovepipe" approach is evidenced most clearly by the fact that the Taxpayer Assistance Blueprint (the TAB) the IRS is preparing pursuant to an Appropriations directive focuses almost entirely on the taxpayer service needs of individuals who earn wages and investment income – despite the fact that the largest segment of the tax gap is attributable to self-employed taxpayers.

As I discussed above, I believe strongly that the goal of a fair and just tax system must be to do everything possible to promote voluntary compliance. This is so, because *voluntary* compliance – as opposed to *enforced* compliance – creates taxpayers who are willing to work with the tax system rather than taxpayers who hide from the tax system. Moreover, in the long run, *voluntary* compliance is the most cost-effective way to achieve lasting compliance.

Both IRS enforcement and service personnel must listen with a keen ear to what each taxpayer is saying to see if there is an opportunity to educate the taxpayer about how to avoid repeating a problem, even as we rectify the current one. If we approach taxpayers as if they are guilty, if we assume that the only explanation for their behavior is intentional noncompliance, if we look at a collection case or an examination not as an

¹¹ For a more detailed discussion, see National Taxpayer Advocate 2004 Annual Report to Congress 211-225 (Most Serious Problem: IRS Examination Strategy); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Committee on Finance on The Tax Gap (Apr. 14, 2005); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, The Judiciary, Housing And Urban Development, and Related Agencies (Apr. 7, 2005); see also Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005); Treasury Inspector General for Tax Administration, Ref. No. 2005-10-159, *A Better Model Is Needed to Project the Return on Additional Investments in Tax Enforcement* (Sept. 2005).

¹² The Government Accountability Office has also recommended that the IRS obtain more and better research regarding the reasons that taxpayers fail to comply with the law. See, e.g., Government Accountability Office, GAO-06-208T, *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-term Goals Are Needed to Improve Taxpayer Compliance* (Oct. 26, 2005).

interaction between a taxpayer and his government but instead as just another case that needs to be closed within a set cycle time – well, we most assuredly will get the behavior from the taxpayer that we expected to see. The reality is that neither is it good for the government and its citizens to be in conflict with each other more than necessary nor do we have the resources to collect our taxes primarily through enforcement actions. That is why achieving a high rate of voluntary compliance is not merely desirable but essential.

Two examples are worth noting:

Federal Payment Levy Program. The FPLP is an automated levy program that systemically matches IRS records against those of the Financial Management Service (FMS) to locate federal payment recipients who have delinquent tax debts. The IRS is authorized to issue continuous levies for up to fifteen percent of federal payments to taxpayers with delinquent tax debts.¹³ As we noted in the National Taxpayer Advocate's 2005 Annual Report to Congress, 84 percent of all FPLP levies over the past four years were issued against Social Security income.¹⁴ When considering that Social Security benefits provide a safety net and may be the sole source of income for many low income taxpayers, the IRS's lack of a screening mechanism to differentiate among taxpayers when imposing FPLP levies is a serious problem. The IRS previously employed such a filter, known as "total positive income" (TPI).¹⁵ In June 2005, however, the Government Accountability Office (GAO) concluded that the TPI was "an inaccurate indicator of a taxpayer's ability to pay."¹⁶ Soon thereafter, the IRS ceased using the TPI as a means to predict hardship status and has not developed a replacement indicator.

TAS has recently reached agreement with the IRS Wage & Investment Division to form a joint task force to further explore the FPLP process as a whole and better address the need for an income filter (or similar mechanism) to minimize the potential for hardship to taxpayers. But an agency charged with serving the needs of the American people should never have allowed procedures to continue for so long that withhold benefit payments without regard to need. This does little to build confidence in the fairness of government.

TAS Relief Rate in Automated Under-reporter (AUR) Cases. The IRS matches return information against wage and other information reporting documents it receives from third parties. Where there is a disparity, the AUR program may automatically

¹³ The Federal Payment Levy Program is authorized by IRC § 6331(h).

¹⁴ National Taxpayer Advocate 2005 Annual Report to Congress 124-130

¹⁵ TPI was based on information taken from the taxpayer's last filed tax return and was calculated by summing the positive values from the following fields: wages; interest; dividends; distributions from partnerships, small business corporations, estates or trusts; Schedule C net profits; Schedule F profits; and other income such as Schedule D profits and capital gain distributions. General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures, Performance and Equity Can Be Improved* 11 (March 6, 2003).

¹⁶ General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures, Performance and Equity Can Be Improved* 11 (March 6, 2003).

generate a notice to the taxpayer. But the AUR program is far from infallible. In fact, among all AUR cases closed by the Taxpayer Advocate Service during the first 9 months of FY 2006, the taxpayer ultimately received full or partial relief in 74 percent of our cases.¹⁷ Particularly as the IRS increasingly automates its enforcement activities, enforcement cannot be simply about flipping on a switch. The IRS must do a better job of monitoring the accuracy of its enforcement programs to ensure that they are well targeted. Where a software program misfires, it is critical that the IRS provide first-rate service to regain the trust of the taxpayers on whom the IRS imposed an unnecessary burden.

C. To Effectively Address the Cash Economy Tax Gap, the IRS Should Initiate a Local Compliance Strategy and Utilize Local and State Data.

Because tax compliance trends and norms are frequently local, it will be difficult for the IRS to develop successful initiatives without local feedback about how its strategies are affecting taxpayers in a given community. The IRS needs such information so that it can adjust its strategy to effectively address local compliance issues. The IRS previously recognized the importance of a local response when it created local Compliance Planning Councils in the mid-1990s and gave them the authority to allocate local compliance resources and research.¹⁸

If the IRS could focus its enforcement and educational efforts on a particular local market, it might be able to change norms of behavior within that market. A local planning organization could work to identify local compliance challenges, direct the IRS's local response, and measure its effectiveness. A national cash economy program office could replicate successful local strategies nationwide.

Moreover, the IRS should use more of the information available from state and local governments, Forms 8300 (Report of Cash Payments Over \$10,000 Received In a Trade or Business), and its audit selection tools to audit taxpayers who are operating in the cash economy and underreporting their income. Although the IRS has access to state and local tax information, reporting on large cash transactions, and computer-based tools to identify underreporting, it used very few of these resources in FY 2005.¹⁹

Many states and localities impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts.²⁰ The IRS should consider

¹⁷ Taxpayer Advocate Management Information System (TAMIS) data (FY 2006 through June 30, 2006).

¹⁸ See General Accounting Office, GAO/GGD-96-109, *Tax Research: IRS Has Made Progress but Major Challenges Remain* 30 (June 1996); Internal Revenue Service, District Office of Research and Analysis (DORA), *Phase I Training Material: IV. Framework; NORA, DORA roles*, 8.

¹⁹ In FY 2005, the IRS considered 1,092 state information items for examination potential, reviewed 2,366 Forms 8300, and closed 15,873 examinations of non-EITC taxpayers filing Schedules C selected using its Unreported Income Discriminant Function (UI-DIF).

²⁰ See, e.g., Fairfax County Code §§ 4-7.2-1 through 4-7.2-36 (2005) (imposing a Business, Professional and Occupational License (BPOL) tax based on gross receipts). See also 18 VAC 50-22-10 (2005) through 18 VAC 50-22-270 (2005), available at <http://www.state.va.us/dpor/Contractors%20Web.pdf>

seeking access to business license tax filings and comparing gross receipts, as reported on those filings, with gross income reported on the taxpayer's federal income tax return. This comparison could help the IRS identify businesses that may be underreporting their income or not filing at all.

D. The IRS Should Strive to Achieve the Correct Results – Not Merely the Results That Maximize Revenue.

When an IRS employee conducts an audit and ultimately assesses and collects additional tax, the IRS views the audit as successful. TAS has found, however, that many taxpayers who “lose” issues on audit and agree to pay additional tax do not, in fact, owe additional tax. “Successful” audits that produce wrong results probably occur most frequently in audits of taxpayers who have the greatest difficulty understanding and complying with IRS requests, particularly via correspondence audits. Low income, elderly, visually or hearing-impaired, and limited-English-proficiency taxpayers are particularly likely to agree to an IRS adjustment, even if wrong, because of their inability to understand the issue and then locate and present the documentation required to substantiate their positions.

In 2004, TAS conducted a study of cases in which EITC claims had been denied and the taxpayer requested reconsideration of the initial IRS determination.²¹ In these cases, 43 percent of taxpayers ultimately received the EITC, and the amount received was, on average, 94 percent of the amount claimed on the original return. In essence, the likelihood that the IRS had obtained the right result the first time was not much better than a coin toss would produce. The study also highlighted the significance of talking with the taxpayer – not merely corresponding – in obtaining the right result. When TAS employees initiated contact with taxpayers by phone instead of relying solely on correspondence, both the likelihood of the taxpayer receiving additional EITC and the amount of EITC received increased with the number of phone calls made by the TAS employee.

Finally, the study found that taxpayers who do not respond to notices are typically no less entitled to prevail in an audit than taxpayers who respond timely. Although many research and academic experts who have examined the EITC program had assumed that non-responders and late responders would be less likely to qualify for EITC benefits than taxpayers who timely responded to requests for information, the study showed that both groups qualified at the same rate. This result is not altogether surprising. For EITC taxpayers – many of whom have low education levels, keep limited records, and may be intimidated at the prospect of battling against the IRS – the failure to pursue a claim may reflect nothing more than difficulty in determining how to pursue it.

(requiring contractors to obtain different contractor license classes based on the value of the contractors' jobs).

²¹ See National Taxpayer Advocate 2004 Annual Report to Congress, Vol. II, *Earned Income Tax Credit (EITC) Audit Reconsideration Study*.

The IRS should not focus on collecting additional revenue at the expense of obtaining the correct result. It is just as important for the IRS to avoid collecting too much tax from taxpayers who don't owe it as to collect taxes due from those who have underpaid.

E. Going Where the Money Is: The IRS Needs To Do More To Improve Compliance in the Cash Economy.

The National Research Program data confirm what most people would intuitively expect. Where taxable payments are reported to the IRS by third parties, the IRS generally collects well over 90 percent of the tax due.²² Where taxable payments are not reported to the IRS by third parties, compliance drops precipitously, probably below 50 percent.²³ Indeed, the IRS estimates the compliance rate for self-employed taxpayers who file a Schedule C is approximately 43 percent, resulting in underpayment of approximately \$68 billion in income taxes alone. For purposes of my testimony, I will use the term "cash economy" to mean all taxable payments that are not reported to the IRS by third parties.²⁴

The cash economy may be responsible for more than a third of the tax gap. The IRS has no direct estimate of the portion of the tax gap attributable to the cash economy. However, according to IRS estimates:

- About 43 percent of the gross tax gap, or \$148 billion a year, is attributable to underreporting of income and self employment taxes by self-employed individuals.²⁵
- Over 80 percent of all individual underreporting is attributable to understated income rather than overstated deductions.²⁶

These estimates suggest that self-employed taxpayers who file returns but underreport their income (or self-employment) taxes represent the single largest component of the tax gap, accounting for more than a third of the gap and over \$100 billion per year.²⁷

²² See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

²³ See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

²⁴ There is no universally agreed-upon definition of the term "cash economy." For a definition similar to mine, see Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate, 108th Cong. 21 (July 21, 2004) (statement of Professor Joseph L. Bankman defining the cash economy as "legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information reporting . . . your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting.").

²⁵ Taxpayers who underreport business income on individual returns account for \$109 billion of the gross tax gap and those who underreport self-employment taxes account for another \$39 billion. IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

²⁶ See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

The IRS has devoted substantial resources in recent years to combating corporate tax shelters and trying to improve standards of conduct among tax professionals. But neither of these priorities addresses the biggest components of the tax gap.

In my annual reports to Congress and in previous congressional testimony, I have offered numerous proposals to help the IRS do a better job at combating the cash economy portion of the tax gap.

Earlier this year, the Small Business/Self Employed Division agreed to establish a joint task force with my office to explore alternatives for improving compliance in the “cash economy” portion of the tax gap. The task force will focus on business transactions conducted on a cash basis where there is currently little or no information reporting. The task force held an initial meeting in April.

The initial goal of the task force is to survey both internal and external sources to identify ideas for improving compliance in this segment of the economy. Task force members are reviewing information from an extensive list of data sources, including the following:

- IRS and TAS studies and recommendations, including the National Taxpayer Advocate’s annual reports to Congress.
- Joint Committee on Taxation (JCT), TIGTA, and GAO studies.
- Academic studies.
- Initiatives undertaken by the states and foreign governments.
- State databases containing sales tax, licensing, and other information.
- Contact points with the Treasury Department’s Office of Tax Analysis (OTA) and the IRS Federal/State Program.
- Suggestions collected from IRS employees through an internal web site.

The task force will develop ranking criteria and complete a ranking process. Ranking criteria will be used to identify the most promising ideas, which will be further researched before a final ranking is developed. We anticipate that the team will present the ranked list to the Commissioner of SB/SE and the National Taxpayer Advocate for consideration.

After obtaining guidance from the Commissioner of SB/SE and the National Taxpayer Advocate, the team intends to fully develop and implement the most promising proposals. This could entail vetting ideas with important external stakeholders, developing legislative and budget proposals, developing implementation plans, and

²⁷ See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

gaining the necessary support from both internal and external organizations to accomplish implementation.

I am hopeful this task force will lead to improved efficiency in IRS operations. As I will discuss below, however, there are limits to what the IRS can do absent congressional action.

IV. Significant Improvements in Tax Compliance Are Unlikely Without Congressional Action.

Notwithstanding my strong belief that the IRS can do more to improve voluntary compliance, the IRS is unlikely to make major strides unless Congress takes steps to make it easier for the IRS to detect noncompliance, primarily through expanded third-party information reporting or withholding. Congress could also improve compliance by facilitating easier payments of estimated tax, improving the offer in compromise program, and strengthening standards in the tax return preparation industry.

A. To Reduce Opportunities for Noncompliance in the Cash Economy, Third-Party Information Reporting Should Be Expanded in Appropriate Cases.

Where payments are subject to withholding, the reporting compliance rate is 99 percent. Where payments are subject to third-party information reporting (e.g., interest and dividend income), reporting compliance is the neighborhood of 96 percent. But where there is little to no information reporting, compliance plummets dramatically to somewhere in the range of about 50 percent overall. This is hardly surprising. Where taxpayers know the IRS is aware they have received income, they realize there is a paper trail and the IRS is likely to come knocking if they fail to report the income on a return. Where taxpayers believe the IRS has no knowledge of an item of income, they realize the IRS is unlikely to find out about it and the temptation not to report it arises.

In considering proposals to expand third-party information reporting, we need to identify various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose.

On the one hand, it would be unacceptably burdensome to impose reporting requirements on all types of transactions. For example, no one wants to be obligated to file a document with the IRS every time he or she takes a cab ride, has someone mow the lawn, or calls a plumber to fix a broken faucet.

On the other hand, some advocacy groups contend that virtually all proposals to expand third-party information reporting are unreasonably burdensome. This position is equally unreasonable. For example, some groups argue that third-party information reporting places a burden on the wrong party. If the *recipient* of a payment fails to report income on his return, they argue, why should the government impose a reporting requirement on the *payer* of that income? After all, the payer hasn't done anything wrong.

The flaw in this argument is that the relatively high compliance rate we enjoy today derives entirely from placing the burden on the payor. When Congress first required employers to withhold taxes and file reports with the government on the payment of wages, similar arguments were raised in opposition. The employer wasn't the one failing to pay taxes, so why burden the employer? When Congress first required banks and other financial institutions to file reports with the government on the payment of interest and dividends, similar arguments were raised again. The financial institution wasn't failing to pay taxes, so why burden the financial institution?

Yet if Congress had not chosen to burden employers and financial institutions in this way, our overall tax compliance rate would likely be much closer to 50 percent than 84 percent. That would be terrible for our economy and for honest taxpayers – including payors of wages, interest, and dividends – since the government would have to double current tax rates to raise the same amount of revenue.

In my view, each proposal to expand third-party information reporting or withholding should be evaluated on its own to determine whether the likely revenue benefits outweigh the likely economic burden the requirement would impose. Let me describe a few situations where I think expanded third-party information reporting should be considered. Under current law, an individual taxpayer can escape information reporting by incorporating. This is true even if the taxpayer is performing the same services that would be subject to Form 1099-MISC (Miscellaneous Income) reporting if the taxpayer were conducting business as an unincorporated entity (e.g., a sole proprietorship).

For Form 1099-MISC information reporting purposes, I believe there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer has incorporated and another has not. There are, of course, many valid reasons for choosing to conduct business as a corporation, but information-reporting avoidance should not be such a reason. Corporate taxpayers who intend to comply with the tax law should have no objections to receiving a 1099-MISC for compensation for services performed or to IRS awareness of this compensation. Thus, we recommend that corporate taxpayers (including Subchapter S corporations) be subject to 1099-MISC reporting requirements to the same extent that unincorporated businesses are today.²⁸

We also recommend that Congress consider requiring information reporting on gross proceeds from sales conducted on Internet auction sites. As with current rules governing Form 1099 reporting, such reports could be subject to a *de minimis* annual exemption (say, \$600). One recent study found that 700,000 Americans reported that

²⁸ We initially recommended that only payments to corporations with 50 or fewer shareholders be subject to income reporting. In subsequent conversations with payroll and reporting professionals, we have been advised that it is often difficult for payors to know the payee's number of shareholders at any one time. These professionals recommend a unitary rule as easier to administer. The National Taxpayer Advocate believes that the precise scope of a corporate reporting requirement should be determined after appropriate research and discussions with affected stakeholders.

eBay sales constitute their primary or secondary source of income.²⁹ The IRS must have the tools needed to address under-reporting of this income.

To cite another example, I recommended in the National Taxpayer Advocate's 2005 Annual Report to Congress that Congress consider requiring broker-dealers to track and report their customer's cost-basis in stocks and mutual funds when sales are made. Under existing rules, brokers are required to file a Form 1099-B (Proceeds from Broker and Barter Exchange Transactions) with the IRS whenever a customer sells a security. However, the reporting rules only require the broker to report the gross proceeds the customer receives upon the sale. The broker does not have to report the customer's cost basis in the security. That omission is significant because a taxpayer's gain or loss on the sale of a security is measured by the excess of gross proceeds over cost basis. Thus, it provides an opportunity for noncompliance.

The absence of a requirement that brokers track and report customers' cost basis in securities has two consequences. First, it often imposes significant compliance burdens on taxpayers who may not have kept track of their cost basis. To illustrate, a taxpayer who has held AT&T stock since the 1980s has received shares in more than a dozen companies over the years, and on each such occasion, the taxpayer's cost basis had to be split between his existing holding and the spun-off company. Similarly, most mutual fund customers elect to have dividend and capital gain distributions automatically reinvested, and the customer's aggregate basis in a mutual fund holding changes upon each such distribution. If taxpayers don't have complete records, they will be unable to determine or substantiate their basis in many instances. We recommended requiring brokers to track and report cost basis primarily because it would make life much easier for honest taxpayers.

But the second consequence of the absence of cost basis reporting is that it affords less honest taxpayers with significant opportunities to overstate their basis and therefore understate their tax liabilities. Reliable estimates of the amount of underreporting in this area are difficult to come by, but two professors have sized the problem at about \$25 billion a year.³⁰ IRS officials studying the NRP data believe the revenue loss is lower, but they agree that the level of underreporting reaches into the billions of dollars. We have spoken with representatives of the brokerage industry and believe on balance that the revenue benefits of requiring brokers to track and report cost basis exceed the burdens the requirement would impose.³¹

²⁹ John Cassidy, *Going Long*, The New Yorker, July 10 & 17, 2006, at 99 (citing an AC Nielsen study).

³⁰ Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question*, 106 Tax Notes 453 (Jan. 24, 2005).

³¹ Congress could consider providing brokers with a one-time credit to offset the cost of implementing a comprehensive basis-tracking system.

B. Where Taxpayers in the Cash Economy are Substantially Noncompliant, the IRS Should Have Back-up Withholding Authority to Drive Compliance.

Because we know that income-reporting compliance is nearly 100 percent when payments are subject to withholding, we are compelled to examine the feasibility of requiring withholding on certain cash-economy payments. We must acknowledge that withholding can impose significant burdens on the payor and in many instances is administratively unworkable. Thus, I am not advocating universal withholding. But we should at least consider the feasibility of the following:

- Entering into voluntary withholding agreements under IRC § 3402(p)(3) with industries or trades that have established payor-payee mechanisms (e.g., travel agencies and travel agents, or hair salons and stylists). The IRS, on a case-by-case basis, could agree to provide a safe-harbor worker classification where the payor enters into a voluntary withholding agreement.
- As discussed in more detail below, actively encouraging self-employed taxpayers to make monthly or even bi-weekly payments toward their estimated taxes through the government's Electronic Funds Transfer Payment System (EFTPS). Where a self-employed taxpayer has been noncompliant for several years running, the IRS could require that taxpayer to make these deposits and could monitor compliance with this requirement closely so as to intervene if the taxpayer misses a required payment. If the taxpayer consistently fails to make required payments, the IRS could impose a back-up withholding requirement, as described below.
- Amending IRC § 3406 to require a form of "backup withholding" by the payor in cases where a taxpayer-payee has a demonstrated history of noncompliance with the tax laws.

For over thirty years in the United Kingdom, contractors in the construction industry have been required to withhold on payments to independent contractors unless Her Majesty's Revenue and Customs (HMRC, formerly Inland Revenue) declares the independent contractor to be exempt from withholding. Independent contractors can obtain exemption certificates from HMRC by demonstrating compliance. This approach has the advantage of making it in the contractor's best interest to employ compliant subcontractors, since most contractors want to minimize their paperwork burden and avoid withholding requirements.

In the National Taxpayer Advocate's 2005 Annual Report to Congress, I recommended that Congress authorize the Secretary to exempt payors from back-up withholding on payments to taxpayers (independent contractors) who present payors with a valid IRS "Compliance Certificate." A taxpayer would be eligible for a Compliance Certificate if he or she has been in compliance with prior filing and payment obligations. If the taxpayer has been noncompliant, the IRS would still issue a Compliance Certificate if, for

example, the taxpayer makes arrangements to satisfy past obligations and schedules a year's worth of estimated tax payments through EFTPS.

The Compliance Certificate could serve as the mechanism for market-driven compliance. When an independent contractor presents a service-recipient with a valid Compliance Certificate, the service-recipient would know there is no risk of backup withholding on payments to that independent contractor. On the other hand, when an independent contractor does not have a valid Compliance Certificate, the service-recipient immediately would know that backup withholding on payments to this independent contractor is possible, if not likely. Moreover, if the service-recipient operates in an industry or industry segment where the IRS has determined that a significant number of substantially noncompliant independent contractors are operating, backup withholding could be mandatory on payments to independent contractors who do not present a valid Compliance Certificate.

Under this recommendation, market forces would act to oblige independent contractors to operate among the ranks of the tax compliant. The easiest way for a payor to avoid a backup withholding situation would be to hire only independent contractors that present a valid Compliance Certificate. It follows that independent contractors who want to work would obtain Compliance Certificates. And in order to obtain a Compliance Certificate, an independent contractor would have to be tax compliant. Thus, tax compliance would become a condition of conducting business.

C. Many Taxpayers Not Subject to Withholding Cannot Save Enough Money to Pay Their Tax Bills, So in Appropriate Cases, We Should Encourage Taxpayers to Schedule Monthly Payments as Automatic Debits from Their Checking Accounts.

Taxpayers who want to comply with their estimated tax payment obligations sometimes fail because the process of estimating income, remembering payment dates, and saving enough money each quarter is cumbersome, especially for self-employed taxpayers who are juggling many different duties and many competing demands on both time and funds. Anything that the IRS can do to help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make such payments is likely to increase compliance.

The IRS should make it just as easy for taxpayers to make their estimated tax payments as it is to pay other bills. Most other creditors send customers bills to remind them when a payment is due, and many creditors offer the option of paying via automatic monthly withdrawals from the customer's bank account free of charge.³² Similarly, the

³² The Treasury Inspector General for Tax Administration (TIGTA) previously recommended that the IRS clearly communicate to taxpayers that EFTPS is free. See 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* 24 (Feb. 2004). This recommendation was based on a taxpayer focus group consensus indicating that taxpayers would not use credit cards to make estimated tax payments because credit card companies charge a convenience fee. *Id.*

IRS could send letters each quarter to self-employed taxpayers who are not making tax payments using the Electronic Funds Transfer Payment System to remind them to make their estimated tax payments. These reminders could point out that taxpayers can use EFTPS, a free service, to make estimated tax payments electronically or by phone and to schedule payments in advance, just like automatic payments to a mortgage lender or utility.³³ The letters should also offer to accept estimated payments monthly or even bi-weekly, just like most other recurring bills.³⁴ Signing up taxpayers for EFTPS could make estimated tax payments almost as automatic as withholding, and that would substantially increase compliance.

D. The Offer in Compromise Program Should Be Strengthened Because It Brings in Revenue and Brings Taxpayers Into Long-Term Compliance.

I recommend that Congress consider measures to expand the offer in compromise program. While I believe the IRS already has the authority to expand this program under existing law, it has repeatedly declined to do so. Why? By definition, only noncompliant taxpayers submit offers since these taxpayers are asking to pay less than the amount the IRS has determined to be due. Thus, it may appear expensive to process and review an offer in compromise, and it may appear that the government is writing off revenue, which some argue may impact other taxpayers' compliance.

On balance, however, I think the offer in compromise program is a good deal for the government. A taxpayer who submits the offer will probably pay more tax dollars into the system in the future as a result of his promise – required with every accepted offer – to be fully compliant for the five succeeding years or else face reinstatement of the tax debt. Five years is a long enough period to enable this taxpayer to learn a new norm of behavior – namely, compliance. And when you compare the 16 cents on the dollar that IRS receives from offers to the virtually no cents it collects after year 3 of the 10-year collection period, many compliant taxpayers might feel that the IRS, by not promoting an efficient and cost effective offer program, is missing a valuable opportunity.

In 1998, Congress directed the IRS in committee report language to expand the bases for accepting offers by considering additional factors such as equity, hardship, and public policy.³⁵ The IRS has been very slow to approve offers on these bases. Although the IRS has begun to accept more of these “effective tax administration” offers in the past two years, it has failed to issue any meaningful guidance to taxpayers or its own employees about what factors it considers in accepting such offers. Thus, I have recommended that Congress consider providing more explicit direction.

³³ Mortgage lenders often require borrowers to pay property taxes into escrow on a monthly basis to ensure that borrowers do not forget to make quarterly or semi-annual property tax payments or spend the funds elsewhere.

³⁴ Some mortgage companies offer programs that electronically deduct mortgage payments bi-weekly rather than monthly.

³⁵ H.R. Conf. Rep. No. 105-599.

I am also very concerned about legislation enacted earlier this year that requires taxpayers submitting lump-sum offers to make an up-front payment of 20 percent simply to have their offers considered.³⁶ I believe this requirement will reduce the number of meritorious offers the IRS receives and, to that extent, will actually result in a reduction in federal revenue.

Taxpayers generally must offer the net equity in their assets plus their future income, after allowance for necessary expenses, for several years.³⁷ Thus, taxpayers must fund offers with assets that the IRS would not ordinarily collect, such as home equity, qualified retirement plans (e.g., an IRA), or unsecured loans or gifts from third parties.³⁸ Many taxpayers will be unable to access these funding sources to satisfy the 20 percent down payment requirement before the IRS has accepted the offer. For example, unless the IRS provides assurances that it will accept the offer:

- A mortgage lender will not lend against property subject to a tax lien;
- A taxpayer might be hesitant to withdraw funds from an IRA, incurring a 10 percent penalty for early withdrawal, because the IRS generally will not levy on a qualified plan, and if it does, no early withdrawal penalty applies;³⁹ and
- A third party such as a friend, relative, or employer who otherwise would give or loan funds for the offer might be less willing to provide funds because the third party cannot be sure those funds will help the taxpayer make a fresh start.

Taxpayers and third parties have no assurance an offer will be accepted at the time the 20 percent down payment is required, especially since the IRS accepted fewer than one in four offers in FY 2006 as of April.⁴⁰ Thus, many taxpayers who would otherwise be able to submit meritorious offers will not be able to do so because they cannot afford to pay 20 percent of the offer amount without any prior assurance that the IRS will accept the offer. Although I realize that Congress just enacted this provision, I think it is bad for taxpayers and bad for revenue. I encourage Congress to revisit this requirement.

E. Strengthening Standards for Unenrolled Return Preparers Would Reduce Noncompliance in the Cash Economy.

The majority of individual taxpayers today use the services of paid tax-return practitioners to prepare and file their individual tax returns, as do most business

³⁶ *Tax Increase Prevention & Reconciliation Act of 2005*, § 509 (amending section 7122 of the Internal Revenue Code).

³⁷ The number of years varies based on the payment term: four years for lump-sum offers, five years for short term deferred payment offers or, for deferred payment offers, the period remaining before expiration of the statute of limitations for collection. See Form 656, *Offer In Compromise*, 6 (Rev. 7-2004).

³⁸ For example, the IRS generally does not levy on retirement plan assets unless the taxpayer's behavior has been "flagrant." IRM § 5.11.6.2 (Mar. 15, 2005).

³⁹ IRC § 72(t).

⁴⁰ SB/SE, Offer in Compromise Program, Executive Summary (FY 2006 (through April 30, 2006)).

taxpayers. Attorneys, certified public accountants, and enrolled agents are all licensed by state or federal authorities, and their right to practice before the IRS is subject to revocation in the event of wrongdoing.⁴¹ Yet there is virtually no federal oversight over “unenrolled” return preparers, who constitute the majority of tax return preparers today.

The IRS does not know how many unenrolled return preparers are actively preparing returns for a fee in the United States. Nor does it know what qualifications and education these preparers possess to prepare returns. While the IRS has a number of initiatives that address the perpetration of criminal schemes by tax preparers, it only conducts a small number of preparer negligence investigations and it collects even fewer dollars in the rare instances that it assesses a preparer negligence penalty.⁴²

Given the role that preparers play in guiding taxpayers through our complex tax laws, it is incumbent on the IRS to register and identify unenrolled return preparers and to administer a basic examination that ensures that persons who prepare returns for a fee have a basic level of competency. The test should contain an ethics component, so that preparers understand the ethical (as well as legal) obligation to accurately report income and expenditures. Moreover, an ongoing education requirement would ensure that preparers are current on tax law changes and learn from the most common mistakes. For example, the most common type of underreporting by taxpayers filing Schedules C (Profit or Loss from Business (Sole Proprietorship)) relates to understated gross receipts or overstated cost of goods sold. With respect to the latter issue, inventory accounting rules are very complex. Unenrolled preparers may not be aware of these complex provisions and thus carry errors forward from one year to the next.

V. Simplifying the Tax Code Would Go A Long Way Toward Improving Compliance.

The legislative actions I described above would help improve the transparency of payments and, to that extent, would largely reduce the opportunities for taxpayers to knowingly understate their income. As I also described earlier, however, many if not most taxpayer errors result from inadvertence and the challenges of understanding and complying with the tax code’s numerous and complex requirements. The tax code runs approximately 1.5 million words, and the administrative guidance interpreting the Code could fill a small library.

Inadvertent errors would diminish dramatically if Congress were to simplify the tax rules dramatically.

I have made specific proposals to simplify portions of the tax code in my annual reports to Congress and in testimony I gave last year before the President’s Advisory Panel on Federal Tax Reform. A detailed description of these proposals is beyond the scope of today’s hearing, but a few examples will illustrate my point:

⁴¹ Circular 230, § 10.50(a).

⁴² General Accounting Office, GAO-04-70, *Tax Administration: Most Taxpayers Believe They Benefit From Paid Preparers, But Oversight for IRS Is A Challenge* 16 (October 2003).

- The earned income tax credit (EITC), a tax provision designed to benefit poor or generally less educated taxpayers, contains 2,680 words and 13 subsections and generally requires at least a 12th grade education to understand. The EITC Information Package published by the IRS contains 53 pages of forms, instructions, and worksheets. Is it any wonder the misreporting rate is high?
- The alternative minimum tax (AMT) is so complex that many affected taxpayers don't realize they owe AMT until they prepare their returns. Although the AMT was originally designed to prevent wealthy taxpayers from using loopholes to escape paying taxes altogether, it now requires millions of Americans who are already paying their fair share to compute their tax liabilities under two sets of rules – and then pay the higher of the two results. Under the regular tax rules, taxpayers are entitled to claim personal exemptions for each member of their family and to deduct state taxes. Under the unique logic of the AMT, the acts of having children or living in a high-tax state are considered tax-avoidance behavior and these tax benefits are lost. Is it any wonder that taxpayers frequently err in computing the AMT – or that taxpayers view the tax code with cynicism?
- Taxpayers saving for their own education or the education of their children face a bewildering array of at least nine separate education credits, deductions, and income exclusions, which collectively contain four different measurements of income, six different income threshold amounts, and three different definitions of “qualified higher education” expenses. Similarly, taxpayers saving for retirement face an array of more than a dozen tax-advantaged retirement planning vehicles. Is it any wonder that taxpayers find the choices confusing or that so many taxpayers inadvertently run afoul of the requirements of these provisions, such as the minimum-distribution or the hardship-withdrawal rules?

Of course, these are just a few examples. But they illustrate why so many taxpayers make inadvertent errors, and they highlight the potential compliance gains we could achieve if Congress were to streamline these provisions and make them accessible to the average taxpayer.

VI. Conclusion

To reduce the tax gap, Congress and the IRS must focus on ways to increase voluntary compliance with the tax code. There is no one-size-fits-all solution. Taxpayers fail to comply with the code for a variety of reasons, and the IRS needs to get a better handle on those reasons in order to develop a more effective compliance strategy. Through an effective combination of improved education, outreach, and assistance and targeted enforcement action, the IRS can improve voluntary compliance. But to make a real dent in the problem, Congress must act. Congress should increase the transparency of economic transactions through third-party information reporting and withholding, in appropriate circumstances, to enable the IRS to detect noncompliance, and Congress should simplify the tax code to make it easier for taxpayers to comply with its requirements.

The largest contributor to the tax gap is the cash economy. The exhibits that follow summarize several proposals I have made in my annual reports to Congress to improve compliance in the cash economy.

Exhibit A: Cash Economy—Administrative Recommendations

Recommendation		Summary	Reason
1	Expand use of EFTPS	Send self-employed taxpayers a letter to remind them when estimated tax payments are due and offer the option of paying electronically, by phone or via automatic monthly (or biweekly) withdrawals from the taxpayer's bank account free of charge.	Self employed taxpayers who want to comply with their estimated tax payment obligations sometimes fail because they have difficulty estimating income, remembering oddly spaced payment dates (April 15, June 15, September 15 and January 15), and saving enough money each quarter. When they fail to pay enough estimated taxes, they are more likely to understate their liability.
2	Revise Form 1040, Schedule C	Include separate lines showing (1) the amount of income reported on Forms 1099 and (2) other income not reported on Forms 1099.	This revision would encourage taxpayers to report income even if it is not subject to information reporting. Taxpayers are more likely to report income that is reported to the IRS by third parties on information returns, such as Forms 1099. Some taxpayers appear to believe that income not reported on information returns is not subject to tax or at least that the IRS will not notice if they do not report it. Separating out gross receipts on the income tax form as we propose would likely improve compliance by emphasizing to taxpayers that income not reported on information returns is still subject to tax. It may also suggest to them that the IRS will notice if they do not report any other income. Another benefit of such a revision is that it would allow the IRS to match the income reported on Schedule C with income reported on Forms 1099 more easily.
3	Revise business income tax return forms	Include two questions: (1) Did you make any payments over \$600 in the aggregate during the year to any unincorporated trade or business? (2) If yes, did you file all required Forms 1099?	These two questions would encourage taxpayers to comply with information reporting requirements. They would also suggest to taxpayers that the IRS is looking at information reporting compliance and that there is additional risk to avoiding the information reporting requirements by paying contractors "under the table." Payments reported to the IRS on information returns are much more likely to be reported on the payee's income tax return. Thus, increased information reporting compliance would cause contractors (payees) to report more of their income.

Recommendation		Summary	Reason
4	Implement more voluntary withholding agreements	Encourage taxpayers to enter into voluntary withholding agreements by agreeing not to challenge the classification of workers who are a party to such an agreement. (Statutory authority exists under IRC § 3402(p)(3), but the IRS may need to work with the Treasury Department to issue regulations before it can use its authority and may prefer additional legislative authority.)	Research shows that taxpayers are most compliant in paying taxes on income subject to withholding. Unlike payments to employees, payments to independent contractors are generally not subject to withholding. Businesses sometimes have difficulty determining whether service providers should be classified as employees or independent contractors and the IRS often challenges such determinations. These agreements could reduce both underreporting by payees and the controversy associated with worker classification.
5	Institute backup withholding more quickly	Require mandatory backup withholding to begin more quickly when taxpayers provide an invalid TIN to the payor.	By the time a payor receives a backup withholding notice from the IRS, the payee (service provider) may no longer be receiving payments from the service recipient. Thus, the IRS has lost the opportunity for backup withholding. For additional information see National Taxpayer Advocate 2005 Annual Report to Congress 238-248 (MSP: Limited Scope of Backup Withholding Program).
6	Use more available information	Use more of the information available from state and local governments as well as information from Forms 8300 (Report of Cash Payments Over \$10,000 Received in a Trade or Business) when selecting returns for audit and when auditing them.	The IRS currently uses information from Forms 8300 to identify returns that may have unreported income. It also receives and uses state income tax audit reports as well as sales tax records, which a cross-functional team has concluded could be used more consistently and effectively. States and localities also impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts. Such information may be useful in detecting unreported income. Local property taxes are also based on the value of real and personal property. Taxpayers whose property holdings are disproportionately large in comparison to the income reported on their federal income tax returns may be underreporting their income. The IRS could combine all of this information, perhaps in conjunction with the UI-DIF (or to improve it), for selecting returns for audit and auditing them.

Recommendation	Summary	Reason
7	Establish local compliance planning organizations	<p>A local planning organization could work to identify local compliance challenges, direct the IRS's local response, and measure its effectiveness.</p> <p>Because tax compliance trends and norms are frequently local, it will be difficult for the IRS to effectively address them without local feedback about how its strategies are affecting taxpayers in a given community. The IRS needs such information and feedback so that it can adjust its strategy to effectively address local compliance issues. If noncompliance is so commonplace in a local market that the price of a good or service does not reflect tax compliance costs, suppliers may be unable to both pay their taxes and compete. However, if the IRS could motivate a critical number of businesses in a given market to report their income, then the market price for their goods or services would increase so that businesses could both compete and pay their taxes. As the IRS's activity starts to affect market prices, research suggests it could produce a dramatic increase in voluntary compliance in the local cash economy as it changes local norms. A national cash economy program office could replicate successful local strategies nationwide.</p>

Recommendation		Summary	Reason
8	Create a cash economy program office	The cash economy program office would coordinate research, outreach, and compliance efforts aimed at improving income reporting compliance among cash economy participants, as the EITC program office has done with respect to EITC compliance.	The EITC Program Office coordinates EITC related activities, measures the results of its initiatives and takes responsibility for ensuring that the program works as intended, even though it relies on many other parts of the IRS to achieve its goals. As with EITC initiatives, responsibility for initiatives that may improve income reporting by cash economy participants is dispersed throughout the IRS. Nobody at the IRS with the authority to coordinate research, outreach, and compliance efforts takes primary responsibility for reducing underreporting among cash-economy participants. As a result, the IRS is not as effective as it could be in improving compliance among cash-economy participants. For example, a cash-economy program office could work with IRS Research to measure the impact of initiatives to reduce underreporting by cash-economy participants. TIGTA and GAO generally agree that such measures would help the IRS to reduce the tax gap. A cash-economy program office could also be justified on the basis that the EITC has a program office and the amount of the tax gap attributable to cash-economy participants dwarfs the amount of the tax gap attributable to EITC claimants.
9	Educate cash economy participants	Educate cash economy participants about the benefits of reporting their income and study the effect of such efforts to determine whether they are cost effective.	In addition to the satisfaction of obeying the law and avoiding potential civil and criminal penalties and interest charges, such benefits may include, for example, an increase in retirement benefits; disability benefits; survivors benefits; Medicare benefits; access to credit; earned income tax credits; and the ability to gain admission to the U.S. or a visa-status adjustment for family members or employees. The IRS could test this concept by educating taxpayers through outreach and various media targeting cash-economy participants in communities where compliance is low and such benefits are not well known. Researchers have suggested that publicity about such benefits, when combined with other enforcement initiatives, may significantly improve reporting compliance in a given community.

Recommendation		Summary	Reason
10	Obtain more and better research	Sponsor research to identify the most effective use of IRS resources after taking into account the direct and indirect effects of IRS activities on tax revenue.	IRS researchers have previously estimated that the indirect effect of an average examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment. However, not all audits have the same effect on compliance. A dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing corporate tax shelters. On the other hand, a dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving EFTPS, and answering tax law questions, has a positive indirect effect on compliance. The IRS does not have current research to show where the next dollar is best spent. We do not even know whether the next dollar is better spent on enforcement or taxpayer service. Thus, in the absence of better research, the IRS cannot make fully informed resource-allocation decisions.

Exhibit B: Cash Economy – Legislative Recommendations

Recommendation	Summary	Reason
1	<p>Amend IRC § 3406 to encourage compliance in certain cash-economy transactions</p>	<p>Amend IRC § 3406 to create a three-pronged reporting and payment system that encourages compliance by:</p> <ul style="list-style-type: none"> ▪ Instituting backup withholding on payments to taxpayers who have demonstrated “substantial noncompliance”; ▪ Releasing backup withholding on payments to taxpayers who become “substantially compliant” and who agree to schedule and make future payments through the Electronic Funds Transfer Payment System (EFTPS); ▪ Providing that payors will not be required to institute backup withholding on taxpayers who present payors with a valid IRS “Compliance Certificate”.
2	<p>Amend IRC § 6302(h) to require IRS to promote estimated tax payments through EFTPS.</p>	<p>Current law requires IRS to use EFTPS to collect at least 94 percent of depository taxes. In contrast, the IRS received less than one percent of all estimated tax payments through EFTPS in tax year 2004.</p> <p>Making estimated tax payments can be cumbersome, particularly for self-employed taxpayers. EFTPS has the potential to alleviate some estimated tax problems because it is convenient and relatively easy to use. Moreover, taxpayers can use EFTPS to schedule automatic estimated payments.</p>

Recommendation	Summary	Reason
3	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding between independent contractors and service-recipients.	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding between independent contractors and service-recipients (as defined in IRC § 6041A(a)(1)), and to specify that independent contractors who enter into voluntary withholding agreements with payor service recipients will be treated as employees only to the extent specified in the agreements, and allow such independent contractors to continue to deduct ordinary and necessary business expenses under IRC § 162(a).
4	Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations.	Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations, as defined in IRC § 7701(2)(3) (including corporations electing to be taxed under subchapter S of the Internal Revenue Code). Taxpayers report 96 percent of income from transactions subject to information reporting. The percentage of reported income decreases significantly, however, when transactions are not subject to information reporting. Under current law, an individual taxpayer can escape Form 1099-MISC information-reporting by incorporating. A taxpayer attempting to avoid 1099-MISC reporting need only include in its business name an indication that it is doing business as a corporation in order to release the service-recipient from the IRC § 6041A reporting requirements. For Form 1099-MISC information-reporting purposes, there should be no distinction between taxpayers who are incorporated and those who are not.

Exhibit C: Requiring Brokers to Track and Report Cost Basis – Legislative Recommendation

Recommendation	Summary	Reason
<p>Amend IRC § 6045(a) to authorize the Secretary of the Treasury to require brokers to track and report cost basis in connection with the sale of mutual funds and stocks.</p>	<p>Amend IRC § 6045(a) to authorize the Secretary of the Treasury to prescribe regulations that require brokers to report information not only regarding gross proceeds but also regarding adjusted basis in connection with the sale of mutual funds and stocks. To facilitate accurate basis reporting, financial institutions that hold mutual funds or stocks for customers should, when a customer transfers assets to a successor financial institution, be required to provide the customer's adjusted basis in the transferred mutual fund and stock holdings to the successor financial institution.</p>	<p>When transactions are subject to information reporting to the government, tax compliance is generally very high – well over 90 percent. The opportunity for noncompliance upon sale of mutual funds or stocks is considerable under current law, because the taxpayer's basis is not reported to the government. This proposal also helps taxpayers (and that was our primary reason for proposing it.) Today, more Americans own stocks or mutual funds than ever before. Most mutual fund investors elect to have their dividend and capital gain distributions automatically reinvested in their funds, causing their aggregate adjusted bases to change upon each such reinvestment. Many mutual fund companies assist their investors by keeping track of adjusted basis, but some do not. With regard to stock investors, most brokers keep track of purchases their customers make, but they do not necessarily update their basis records to reflect stock splits, spin-offs, and other corporate restructurings. While taxpayers are properly required to keep adequate records to substantiate their tax reporting, the reality is that some investors hold stocks or mutual funds for decades, and it is simply not realistic to expect that all taxpayers will keep perfect records for long periods of time.</p>