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ON
THE TAX GAP AND HOW TO SOLVE IT
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Introduction

Chairman Gregg, Senator Conrad, and Members of the committee, I am pleased to be here today to discuss the latest information we have on the tax gap. I also want to discuss steps we are taking to reduce the gap as well as some specific changes in the law that will enable us to do an even better job in the future.

Background:

The tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. While no tax system can ever achieve 100 percent compliance, the IRS is committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time. Moreover, because the complexity of our current tax system is a significant reason for the tax gap, fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions in the tax gap.

Last March, the IRS released preliminary results of our analysis of the compliance data recently compiled by the National Research Program (NRP). These preliminary results were for Tax Year 2001 and were the first such comprehensive numbers available since 1988. We have done several much narrower studies since 1988, but nothing that would allow us to comprehensively update our estimates of the overall tax gap.

Prior to the early 1990s, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line by line audits of random samples of returns. This provided us with information on compliance trends and allowed us to update audit selection formulas. The NRP was born out of our effort to find a less intrusive way to measure compliance with the tax laws.

The NRP introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study. These innovations included the compilation of a comprehensive set of data to supplement what was being reported on select returns; the introduction of a classification process that helps identify how best to handle each return in the sample; and the streamlining of the collection of data which, among other things, provided auditors with new tools to detect noncompliance.

A focused statistical selection process resulted in the NRP sample including approximately 46,000 returns, somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time. Clearly the NRP approach was much less burdensome on taxpayers than the old TCMP audits, which required the taxpayer to support the entry made on every line on the return. At the same time, we expect that the data collected through the NRP sample will be about the same quality as the data collected under the TCMP.

One of the other advantages derived from the NRP study is the opportunity to update our discriminant function (DIF) formulas. The DIF system is a well known statistical technique that the IRS has been using since the early 1970's. It is designed to help us choose which returns merit further examination and to avoid examining compliant taxpayers.

Using the recent NRP study data, we have developed new DIF formulas for several examination classes. IRS implemented these new formulas in January 2006 to evaluate Tax Year 2005 returns. We will begin examining returns selected using these new formulas in October 2006. We believe using the new formulas will allow us to improve productivity and reduce taxpayer burden by reducing significantly the number of examinations resulting in little or no change to the taxpayer's tax liability.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the study is on individual income tax returns. It does not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. The numbers we use for those estimates of compliance with taxes other than the individual income tax are still based on rough projections that assume no change in compliance behavior among the major tax gap components since the most recent compliance data were compiled. (i.e.,1988 or earlier).

I would note, however, that we have just announced the latest NRP study which will assist us in better analyzing both the individual and corporation income tax gaps. Specifically, the newest NRP study will focus on S Corporations, the most common corporate entity. In 2003, nearly 3.4 million S corporations filed tax returns, accounting for over 58 percent of all corporate returns filed that year.

With this new study we will gauge the extent to which the income, deductions, and credits of S corporations are properly reported on the returns filed by them and their shareholders. This study will serve as a complement to the individual reporting compliance study.

Distinguishing the Tax Gap From Related Concepts

The tax gap is not the same as the so called "underground economy", although there is some overlap (particularly in the legal-sector cash economy). For example, the tax gap does not include the illegal sector of the economy and the underground economy does not include certain types of tax noncompliance such as overstated deductions or claiming improper filing status.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, though, at this point, we do not have sufficiently good data to help us know how much arises from willfulness as opposed to innocent mistakes. This is an area where we expect future research to improve our understanding.

Latest Numbers

Historically, there are three types of income that are not well represented in compliance audits: informal supplier income, tip income, and unreported income that is not detected by auditors. We have taken the preliminary analysis done last March and supplemented it with other data and special analyses to account more accurately for these three income types. In the past, these supplemental analyses have taken several years to complete after the audit data became available. Utilizing new technologies, we have been able to refine the data over the past several months.

These numbers showed that there is an overall gross tax gap of approximately $345 billion, leading to a noncompliance rate of 16.3 percent. Both of these numbers are in the upper end of the range of estimates provided last spring.

The net tax gap or what is remaining after enforcement and other late payments is $290 billion, also in the upper end of the earlier range.

Noncompliance takes three forms: not filing required returns on time; not reporting one's full tax liability even when the return is filed on time; and not paying by the due date the full amount of tax reported on a timely return. We have separate tax gap estimates for each of these three types of noncompliance.

Underreporting constitutes nearly 82 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes 8.6 percent and underpayment 9.6 percent of the gross tax gap.

Individual income tax accounts for 46 percent of all tax receipts. However, as shown on the chart on the next page, *individual* income tax underreporting is approximately $197 billion. This constitutes about 56 percent of the overall tax gap. While a comparison with 1988 data would suggest a slight worsening of individual income tax reporting compliance, it is important to remember that the data tell us nothing about the years just before or just after Tax Year 2001 and, as such, cannot tell us whether compliance trends today are improving or getting worse.

As in previous compliance studies, the NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent ($56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated subtractions from income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits.

NRP-Based Tax Gap Estimates, Tax Year 2001

Tax Gap Component	*Gross Tax Gap ($ billions)*	*Share of Total Gap*
Individual income tax underreporting gap	**197**	**56%**
Understated non-business income	56	16%
Understated net business income	109	31%
Overstated adjustments, deductions, exemptions and credits	32	9%
Self-Employment tax underreporting gap	**39**	**11%**
All other components of the tax gap	**109**	**33%**
Total Tax Gap	**345**	
Note: Detail does not add due to rounding		

The corresponding estimate of the self-employment tax underreporting gap is $39 billion, which accounts for about 11 percent of the overall tax gap. Self employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self employment tax together, then, we see that individual underreporting contributes nearly 70 percent of the overall tax gap.

It appears that compliance rates for sections of the Form 1040 where the most noncompliance occurs have not changed dramatically since the last compliance study in 1988. The amounts least likely to be misreported on tax returns are subject to both third party information reporting and withholding and are, therefore, the most "visible" (e.g., wages and salaries). The net misreporting percentage (NMP) for wages and salaries is only 1 percent.

Amounts subject to third-party information reporting, but not to withholding (interest and dividend income), exhibit a somewhat higher misreporting percentage. For example, there is about a 4% percent misreporting rate for interest and dividends.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher misreporting percentage (e.g., 12 percent for capital gains). As expected, amounts not subject to withholding or third party information reporting (e.g., sole proprietor income and the "other income" line on form 1040) are the least "visible" and, therefore, are most likely to be misreported. The misreporting estimate for "other income" is 64 percent or $23 billion of tax.

With transactions that are less "visible" to the IRS, and with very low audit rates by historical standards, some sole proprietors may have become emboldened to cut corners on their taxes. Other small business owners may be swamped by the cost and complexity of meeting their tax obligations and their business requirements. Whatever the reason, it is easy to see that we have a serious problem with underreporting for those items not subject to withholding or third party information reporting.

What We Are Doing Today to Address the Tax Gap

We recognize that the best way to address the tax gap is to maintain a balance between service and enforcement. Our mantra is that Service + Enforcement = Compliance.

The Tax Code is extremely complex and it is easy even for sophisticated taxpayers to make honest mistakes. The IRS has an obligation to assist taxpayers in both understanding the tax law and remitting the proper amount of tax. In 2006, we will maintain a strong service focus. We have updated our website to allow taxpayers to find out if they qualify for the earned income tax credit or whether they will be subject to the alternative minimum tax. Through our FreeFile program, 70 percent of all individual taxpayers can now file their federal taxes electronically at no cost. Returns filed electronically have a significantly lower risk of error, saving time and resources for both taxpayers and the IRS.

The level of electronic filing continues to grow and as a result, refunds are processed faster than ever. The accuracy of answers that taxpayers get when they reach our call centers continues to rise and the level of expertise at our volunteer income tax assistance centers (VITA) has never been better.

Most Americans pay their taxes honestly and accurately, and have every right to be confident that when they do, their neighbors and competitors are doing the same. When their neighbors and competitors let them down and fail to file properly, the IRS has an obligation to respond.

I have talked about some of our service initiatives. Let me provide you an overview of the steps we are taking from an enforcement perspective to bolster the confidence of the American people that all are paying their fair share.

We have several enforcement priorities, one of which is to discourage and deter non-compliance, with an emphasis on corrosive activity by corporations, high income individuals, and other contributors to the tax gap.

- In 2005, we audited nearly 220,000 high income taxpayers, more than double the number audited in 2000.

- Overall, audits for individuals reached 1.2 million, 20 percent more than 2004 and almost double the level five years earlier.
- In 2005, we audited nearly 5000 businesses with assets over $250 million, an increase of 11 percent. In addition, we audited one out of every five companies with assets of $10 million. Finally, audits of businesses with less than $10 million in assets rose 145 percent from 2004.

Enforcement revenue from audits of corporations and individuals hit $17.7 billion in 2005 compared to $10.7 billion in 2003. In all, collections from heightened enforcement efforts rose 10% in 2005 moving from $43.1 billion in 2004 to $47.3 billion in 2005

The centerpiece of our enforcement strategy is combating abusive tax shelters, both for corporations and high income individuals. About 22 months ago we made a settlement offer regarding the Son of Boss tax shelter. For the first time, the IRS required a total concession by the taxpayer of artificial losses claimed and, for most taxpayers, required a payment of penalties. Nearly 1200 taxpayers have participated in that initiative and we have collected $3.8 billion in taxes, interest, and penalties.

In addition to Son of Boss, last October we announced a global settlement initiative that covered 21 listed and non-listed transactions. They include a wide cluster of transactions involving funds used for employee benefits, charitable remainder trusts, offsetting foreign currency contracts, debt straddles, lease strips, and certain abusive conservation easements.

Taxpayers had until January 23, 2006 to file an election to take part in the global settlement program. Under the terms of the settlement, taxpayers will be required to pay 100 percent of taxes owed, interest and, depending on the transaction, either a quarter or half the accuracy-related penalty the IRS will otherwise seek

We have been pleased by the response to this initiative and we believe the response was buoyed by the provisions of the Gulf Opportunity Zone Act of 2005 that modified the rules for calculating interest on tax deficiencies of individual taxpayers who participated in certain abusive tax shelters and increased incentives for individuals to come forward as part of this program.

In addition, our Large and Mid-Sized Business Division has issued more than 500 administrative summonses as part of our attack on shelter promoters, and we have approximately 200 active promoter examinations under way. Entities being looked at include banks, accounting firms, law firms and brokerage houses. We want to make it clear that taxpayers who take aggressive return positions relying on the “audit lottery” and the chance they will not be examined have made a really bad decision.

Combating abusive tax shelters will remain a top priority in 2006. We will not let our guard down. Our plan is to focus on improper uses of tax exempt bonds and trusts, questionable transfer-pricing practices, offshore accounts, and charitable donations of intangible assets.

We are also getting help in our efforts from other Federal entities. The Financial Accounting Standards Board recently issued Proposal 109, which stipulates that in order to show the net financial benefits of a tax position, the treatment must have a "probable" recognition threshold, which is commonly interpreted as at least a 70 percent likelihood of being upheld. Previously, the wording was "more likely than not", that is, more than 50 percent.

The Securities and Exchange Commission is also increasing the information it shares with us. As a result, the new transparency on financial statements, as required under the Sarbanes-Oxley Act, will have growing significance for tax compliance.

Another enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures.

In some cases, this erosion reaches criminal levels. In 2005, we initiated 248 criminal investigations of tax preparer fraud. This is in addition to cases in which, we either have indictments or pending convictions involving criminal behavior. In 2005, 118 tax preparers received sentences from a judge. Nearly 86 percent were incarcerated and the average sentence was 18 months.

We have done quite a bit to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. Treasury regulations set forth rules governing what does and does not qualify as an independent opinion about a tax shelter. Specifically, new Treasury Department regulations took effect last June which revise Circular 230 governing tax practitioner behavior. The new regulations establish standards for written tax advice prepared by practitioners.

Further, additional revisions to Circular 230 were recently proposed to make disciplinary proceedings more transparent so that practitioners may learn the types of behavior IRS is likely to challenge under the Circular.

The IRS has made noncompliance by tax exempt and governmental entities and misuse of the tax exempt status of such entities by third parties for tax avoidance purposes, another major enforcement priority.

For example, earlier this year, we concluded that more than 30 credit counseling firms, accounting for more than half of the industry's revenues, are not entitled to tax exempt status. The revocations of the tax exempt status of these entities are the culmination of more than two years of work covering more than 60 credit counseling organizations.

These organizations were granted tax exempt status originally because they were supposed to be educating and assisting people who have credit or cash flow problems. Unfortunately, too many of these organizations, instead, operate for the benefit of insiders or are improperly in league with profit making companies.

Another example of our recent enforcement efforts is the high profile case of Richard Hatch, the winner of $1 million on the first season of *Survivor*. He was recently convicted for tax evasion for failure to report that and other income to the IRS. However, he was also using a charity to shelter some of that income. In addition, he was accepting money on behalf of the charity and channeling it for his own personal use.

We want to make sure that when people donate money to charities that it is going for the purpose intended and not into the pockets of some individuals associated with the charitable organization.

In 2006, the tax exempt sector will continue to focus on key areas where organizations are abusing their exempt status or where others are using them for unintended purposes. Three of the areas in which we anticipate renewed enforcement include political intervention, compensation and abusive transactions.

Relative to political intervention, we will be finishing up in 2006 contacts with 130 organizations suspected of political intervention in the 2004 election. Almost half of these are churches. Most of the problems we are finding in this area are one-time events that can be easily resolved. However, we continue to get reports of tax exempt entities possibly crossing the line in this area.

Excessive compensation of executives will also be a main focus of our enforcement efforts. There are indications that organizations have allowed key executives too great a voice in determining their own compensation or otherwise have not done due diligence in setting compensation levels. We have contacted almost 2000 Section 501(c)(3) organizations including about 400 private foundations. In addition, we are exploring hospitals and their compensation to executives.

As far as potentially abusive transactions go, I have already spoken about our global settlement initiative. At least ten of the transactions included in this initiative involve our Tax Exempt/Government Entities division (TE/GE).

FY 07 Budget Proposal

Secretary Snow will soon appear before this committee to discuss the FY 07 budget proposed by the President. Included in that budget is a recommendation for the IRS.

As with other federal agencies, the budget recommendation for IRS demands increased efficiencies in our overall operation and will require that we all do more with less. The proposed budget for FY 2007 is $10,591,837,000 in direct appropriations supplemented by $135 million in increased user fees for a total operating budget of $10,726,837,000. This represents a 1.4 percent increase from the FY 06 enacted level and we believe it will allow us to continue the balance between service and enforcement that is so critical in tax administration.

Of the total request, $6.961 billion in direct appropriations is requested for enforcement, an increase of $137 million or two percent more than FY 2006. However, this enforcement increase is requested as a program integrity cap adjustment similar to the adjustment enacted in FY 2006. And, as with FY 06, the $137 million increase and the $6.824 base will be “fenced” so as to specify that the funding can only be used for enforcement.

It was this committee that last year recognized the importance of IRS’s enforcement initiatives and included the program integrity cap adjustment in the Budget resolution. That adjustment is now being used to support many of the enforcement activities I enumerated earlier.

I wish to express my deep appreciation to this committee for taking that action last year.

The cap adjustment requested this year is somewhat different than the one in the FY 06 budget. Last year the $446 million increase actually helped supplement enforcement program initiatives. The $137 million requested for FY 07 is what is needed to pay the cost increases associated with the FY 2006 enforcement base.

In other words, approval of the $137 million in the FY 07 request is necessary in order to reap the full benefits of the investment made in enforcement last year, an investment I would remind the committee has paid off handsomely for American taxpayers.

Although not directly connected, the IRS yields approximately four dollars in direct revenue for every additional dollar spent in its enforcement efforts. In FY 2005 we brought in a record of $47.3 billion in enforcement revenue, an increase of $4.2 billion from the previous years.

Beyond the direct revenues generated by increasing audits, collection and criminal investigations, our enforcement efforts have a deterrent effect on those who might be tempted to skirt their tax obligations.

It is important that we not allow the tax cheats and those who seek to game the system a chance to get back on the offensive. The investments we made in enforcement last year have them on the run. Let’s not undermine that progress by failing to fund the $137 million it takes to pay cost increases out of the FY 2006 base.

Legislative Proposals to Reduce the Tax Gap

Please imagine if you will that each of our enforcement initiatives is a tool. Collectively, as I have enumerated above, these tools make a pretty impressive tool belt. However, with more tools in our belt, we should be able to accomplish even more. As part of his FY 2007 Budget proposal, the President proposed several legislative changes that would add additional tools to our belt and help to reduce the tax gap.

The five changes proposed by the President would generate $259 million in increased collections in FY 07 and, over the course of the next ten years, a total of $3.6 billion. Allow me to address each of the proposals individually.

The first proposal would clarify when employee leasing companies can be held liable for their clients' Federal employment tax. Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Typically, these firms prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of the clients' workers.

Non-compliance with the Federal employment tax reporting and withholding requirements is a significant part of the tax gap. Under present law, there is uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to the wages paid by a company that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes are assessed and collected.

The Administration's proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also provide standards for holding employee leasing companies solely liable if they met certain specified standards.

The second proposal would increase reporting on payment card transactions. Payment cards (including credit cards and debit cards) are a growing form of payment in retail business transactions. The failure of some retail businesses to accurately report their gross income, including income derived from payment card transactions, represents a significant portion of the tax gap.

Specifically, the Administration proposes that the Treasury Secretary be given the authority to promulgate regulations requiring annual reporting of the aggregate reimbursement payments made to merchants in a calendar year, and to require backup withholding for card issuers in the event that a merchant payee fails to provide a valid taxpayer identification number.

It is clear that increased information reporting and backup withholding are highly effective means of improving compliance with tax laws. Because reimbursement information is provided to merchants, requiring this information to be reported to the IRS on an aggregate annual basis will impose minimal burden on card issuers. In addition, implementing a backup withholding system for payment card reimbursements to businesses would lead to material improvements in the compliance rates of these taxpayers without imposing a significant burden.

Our third proposal would require increased information reporting for certain government payments for property and services. In March, I will be testifying before the Senate Permanent Subcommittee on Investigations. The subject of that hearing will be to follow- up on an earlier hearing that looked at the number of Federal contractors who themselves are delinquent in their Federal taxes. GAO identified 97 such cases and we have, or will be soon looking at each of these.

As strange as it may seem, government at all levels does business with vendors who are delinquent on their taxes. Our proposal would authorize the Treasury Secretary to promulgate regulations requiring information reporting and backup withholding on non-wage payments by Federal, state and local governments to procure property and services. Certain payments would, of course, be exempt. These include payments of wages and interest, payments for real property, payments to tax exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract.

The fourth proposal would amend collection due process procedures for employment tax liabilities. Employment taxes constitute one-fifth of the IRS total inventory of unpaid taxes. Currently, we are authorized to take various collection actions including issuing Federal tax levies. Before a tax levy can be issued, however, the IRS must provide the taxpayer with a notice and an opportunity for an administrative collection due process (CDP) hearing, and for judicial review.

Frequently, an employer who fails to satisfy its Federal tax liabilities for one period will also fail to satisfy them for later periods resulting in a “pyramiding” of unpaid taxes. Some employers who request a CDP hearing or judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities during the CDP proceedings. Liabilities for the subsequent periods cannot be collected by levy until the employer has been given notice and opportunity for hearing and judicial review for each period.

Our proposal would allow the levy to be imposed prior to a CDP hearing in a fashion similar to levies issued to collect a federal tax liability from a state tax refund. Taxpayers would have the right to a CDP hearing with respect to employment tax liabilities within a reasonable time after the levy.

The final legislative proposal would expand the signature requirement and penalty provisions applicable to paid tax preparers. Under current law, paid tax return preparers are required to sign and include their taxpayer identification number (TIN) on income tax return and related documents that they prepare for compensation. Paid return preparers, however, are not required to sign and include their TINs on non-income tax returns or related documents such as employment tax returns, excise tax returns, and estate and gift tax returns. The Administration's proposal would expand preparer identification and penalty provisions to non-income tax returns. Further, it would impose penalties for preparing non-income tax return related documents that contain false, incomplete, or misleading information or certain frivolous positions that delay collection.

Conclusion

On the whole, our system of self-assessment of tax liabilities works well. Most countries would be thrilled to have a voluntary compliance rate of almost 84 percent.

We owe it, however, to compliant taxpayers to do everything we can to make sure we collect the other 16 percent. Otherwise, the legitimate taxpayers are asked to carry an unfair and unnecessary burden.

It is clear that consistent efforts to keep the complexity and unnecessary burden of the tax system to a minimum, to provide the excellent service that the taxpaying public deserves, and to maintain a strong and well targeted enforcement presence are necessary to improve compliance rates.

We will continue our efforts to maintain the balance between service and enforcement, but it is a balance. In addition to providing excellent service and maintaining a strong respect for taxpayer rights, we must have the resources and the tools to enforce the laws. Adoption of the President's budget request for our agency along with the five legislative proposals will make sure we have those tools for another year.

Thank you for the opportunity to discuss the tax gap and our efforts to combat it. I am happy to take your questions.