

**DECONSTRUCTING THE TAX CODE: UNCOLLECTED
TAXES AND ISSUES OF TRANSPARENCY**

HEARING

BEFORE THE

FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT
INFORMATION, AND INTERNATIONAL
SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON
HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
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TUESDAY, SEPTEMBER 26, 2006

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:36 p.m., in room SD-342, Dirksen Senate Office Building, Hon. Tom Coburn, Chairman of the Subcommittee, presiding.

Present: Senators Coburn, Carper, and Akaka.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. The Federal Financial Management Subcommittee of the Committee on Homeland Security and Governmental Affairs will come to order.

I want to first take a moment—we delayed, waiting for Senator Carper to be here. I understand he will be here shortly. I want to thank each of our panel participants today for participating in this, and I have a complete statement that I will put into the record.

We had our first hearing some months back on the tax gap, and it is to Senator Carper's credit that we continue to follow this. It is not just about controlling spending, but it is also about collecting the revenue that is due. And we are going to have a wide view of positions put forth today, both on tax expenditures—which I do not know how we ever coined that word because the assumption behind a tax expenditure is the government should have all the money and what they do not take is a tax expenditure. We are going to talk about that. We are going to talk about the IRS' plans on the tax gap, as well as Senator Bayh's bill on terms of reporting capital gains, which I support and have co-signed as a cosponsor on, which I think as a minimum needs to be done.

I am pleased with what we have heard in the testimony. I have read all the testimonies and seen the summaries. I think there are a lot of ideas.

There is no question that in our country one of our biggest problems in creating the tax gap is not intentional non-compliance but the complexity of our Tax Code. And at some point in the future, the American people are going to demand that we make it simpler, fairer, and more easily transparent so that you can fulfill your obli-

gation as a citizen of this country and participate in funding the real obligations of our country.

President Bush called our tax program a “complicated mess.” I think if you look at anybody out there who has any other than one source of income and that can do a simple, straight-line form, everybody would agree with that, whether you are on the side of preparing it—and I will never forget the study that was done when I was in the House where we took 10 different accounting firms to 10 different locations with 10 different IRS locations, and everybody came up with a different answer on exactly the same facts, which proves the point.

So I will not belabor my point. I am extremely thankful for Senator Carper and his insistence, and also Senator Lautenberg, as we look at tax expenditures because there are loopholes or intended expenditures that are not necessarily in sunshine, in sunlight, that the American people ought to know about. And they ought to know where we are not taxing and what the intended benefit with that should be.

[The prepared statement of Senator Coburn follows:]

PREPARED STATEMENT OF SENATOR COBURN

As anyone knows who has ever barely made it to the post office in time on April 15, the tax code can be a nightmare. President Bush has called it “a complicated mess.” Riddled with exceptions, credits and deductions, the United States has the most complex tax system in the world. In many ways, the tax code is designed to strengthen our economy by its incentives such as encouraging small businesses to thrive by raising expensing limitations, and helping those who have decided to return to school through education tax credits.

In other ways, however, because of its inherent complexity, the tax code is difficult for Americans to understand. We have a whole industry of professionals for hire to help you file your returns. Some people have used this complexity to their advantage and cheated the system. Others—which I believe make up the majority of taxpayers—are trying to do the right thing but may fail to accurately file a return and what deductions or credits they are eligible or ineligible to claim.

Today we are here to talk about several important issues relating to the transparency of our tax system. Increased transparency means better data, recordkeeping and reporting about uncollected taxes. You cannot treat a disease until you diagnose it.

The gap between revenues that should have been collected and those that actually were is known as the “tax gap.” According to the Internal Revenue Service’s most recent estimate, the tax gap was \$345 billion for tax year 2001. Everyone wants the tax gap closed—we can’t afford it with a \$550 billion deficit—we are mortgaging our children’s future. If we closed it today, we would eliminate the deficit in less than two years. We don’t know the size of, scope of, and reasons for the problem. Either the IRS must find a way to develop a more precise picture of where money is being lost; or Congress better get moving on fundamentally revamping the tax code.

I believe the biggest rate limiting step here is uncovering motive. IRS can’t distinguish who is intentionally evading paying taxes versus those who unintentionally underreport or misreport their taxes. The “fix” we invest in is entirely dependent upon knowing how much of our problem is intentional—that is an enforcement problem—and how much is unintentional, where the solution is education and simplification.

One proposed solution is to require securities brokerage firms or mutual funds to track and report the adjusted basis a taxpayer has in his or her stock, bond, and mutual fund investments to both the IRS and the taxpayer. Some have suggested this could save as much as \$25 billion a year; IRS estimates it could save around \$8 billion annually. Some argue it’s too burdensome on industry, but others say many firms already have this information, and reporting it to the IRS wouldn’t be too hard. I’m eager to discuss the idea more with our witnesses.

Last October, IRS reported before this Subcommittee that it had estimated the tax gap to be somewhere within the range of \$311 and \$353 billion for the 2001 tax year. Unfortunately, last October, 4-year old data was the most recent data we

had. Today, revised four-year old data is the most recent we have. In 2006, IRS came out with its revised estimate, which put a price tag on the 2001 tax year to be \$345 billion. Until this morning, the IRS had no plan to regularly measure compliance.

The IRS hopes to eventually recover \$55 billion in late payments and taxes, bringing the net tax gap down to \$290 billion for tax year 2001, but the Treasury Inspector General for Tax Administration (TIGTA) questioned this figure. The IG says that because IRS currently does not correlate either type of payment to the applicable tax year, IRS will be unable to determine whether the \$55 billion is ever collected. How can we insure that \$55 billion will be collected against the 2001 tax gap if we don't assign money as it comes in to its applicable tax year?

The IRS balances its approach to tax gap reduction by focusing on both prevention—that is, improving taxpayer services—and enforcement after the fact. I am not convinced that this is as thorough a plan as a \$345 billion tax gap deserves. At our last hearing we learned that there are no official long-term compliance goals driving IRS' efforts, other than to continue to serve taxpayers and enforce the tax code through audits and examinations. There has been ample pressure by Congress on the IRS to make a plan to close the tax gap, yet there is still no clear plan. While tax reform may be on the horizon, we still must be good stewards of our existing resources under our existing tax regime, as oppressive as it might be.

I am encouraged that the IRS has taken Congress' oversight seriously and is planning a strategic approach to reducing the tax gap, including plans to regularly measure compliance. I am even more pleased that the Treasury Department is studying the report of the President's Advisory Panel on Tax Reform and is considering options for simplification of the tax system.

Another issue we are here to discuss today is the transparency of tax preferences. As we go forward to make more information public on the categories and amounts of tax deductions benefiting certain types of filers, we need to obey important privacy laws.

We have a lot to cover today, so I think you all ahead of time for your patience. I want to thank our witnesses for their time and preparation, and thank Senator Carper and Senator Lautenberg for their help in pushing for this hearing.

Senator COBURN. So, with that, I will turn to Senator Akaka for his opening statement, and we will proceed.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you, Mr. Chairman, for calling today's hearing. It is a very important hearing. We are joined today by several panels of distinguished witnesses, which includes Internal Revenue Service Commissioner Everson and the National Taxpayer Advocate, Nina Olson, who has been a tireless advocate for taxpayers' rights.

The tax gap is even more important than ever because of the need to shrink our deficit. I have long been concerned about the reduction in taxpayer services provided by the IRS. Helping taxpayers who want assistance in filing their taxes correctly will help reduce this tax gap.

In fiscal year 2003, according to data from the Wage and Investment Operating Division, the IRS prepared 665,868 returns. However, the IRS has reduced the number of prepared returns each year. Plans for fiscal year 2006 indicate that only 305,000 returns will be prepared by the IRS. This is a reduction of more than 50 percent in 3 years.

In my home State of Hawaii, I have seen the effects of the reduction. For years, the IRS and Hawaii State Department of Taxation had made it an annual practice to help prepare returns on the island of Molokai. They typically help more than 100 taxpayers within 2 days. This service has been extremely helpful because there has been only one individual that provides paid tax preparation on the entire island. Then a few years ago, the IRS ended its partici-

pation in the partnership. AARP stepped in to help out for a year, and thankfully, the IRS again took part in the program this past filing season. However, it is uncertain whether the IRS will help out Molokai taxpayers for the upcoming filing season. In addition, the Hawaii Taxpayer Advocate's Office has seen a significant increase in the number of people seeking help with their tax questions because they have been unable to get the answers or assistance that they need from the IRS.

Due to the complex nature of the Tax Code and the importance of voluntary compliance in helping reduce the tax gap, we must make sure that the IRS has the resources to provide assistance to those that seek out help. Reducing these services may result in a larger tax gap.

Mr. Chairman, I am also disappointed by the often poor quality of paid tax preparation services. Errors made by paid tax preparers contribute to this tax gap, too. Senator Bingaman and I have been advocates of legislate to regulate tax preparers for many years. I appreciated the contributions to this issue from Senators Grassley and Baucus, and I remember hopeful that one day we will be able to pass the Taxpayer Protection and Assistance Provisions found in the Finance Committee-approved Telephone Excise Tax Repeal and the Taxpayer Protection and Assistance Act of 2006. This bill would also expand access to free tax preparation services for low-income taxpayers.

In addition, the legislation includes the Free Internet Filing Act, which will empower individual taxpayers to file their taxes electronically through the IRS website without the use of an intermediary or with the use of an intermediary with which the IRS contracts to provide free universal access. If taxpayers take the time necessary to prepare their own returns, they must be provided with the option of electronically filing directly with the IRS.

As the National Taxpayer Advocate has stated, nearly 45 million returns prepared using software are mailed in rather than electronically filed. With universal access to free e-file, this number could be substantially reduced. Electronic returns help taxpayers receive their refunds faster. This would also save the IRS resources and reduce possible errors that can occur when mailed-in returns are transcribed.

Mr. Chairman, I look forward to a thorough discussion of these issues as part of today's hearing on the tax gap, and I thank the witnesses for appearing this afternoon.

Thank you very much, Mr. Chairman.

Senator COBURN. Thank you, Senator Akaka, and publicly to acknowledge your victory this past week, we congratulate you.

Senator AKAKA. Thank you.

Senator COBURN. Senator Carper.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. I want to join in that congratulations. I am happy for you, happy for the folks of Hawaii, at least thus far, and really happy for us. Congratulations. I realize there is another election to come, and we wish you well there as well.

I want to thank you, Mr. Chairman. I have been looking forward to this day. I understand some of our friends on another committee

have written to us to remind us of their jurisdiction on legislative issues on tax matters, and we appreciate that.

Senator COBURN. Let me just interrupt. Federal financial management is unlimited when it comes to either receiving dollars or spending dollars, and we are not going to limit our inquiry into waste, fraud, abuse, or inefficiency.

Senator CARPER. Good. I could not have said it better myself.

As we all know, each year the amount of money that is paid into the Treasury is a good deal less than what is owed. I have a statement I am going to enter for the record, but I think in February this year, the IRS estimated there was about \$345 billion that was due from last year, and after money came in, we ended up with still about \$290 billion less than what we should have had. That is, I think, actually more than the projected deficit for the current fiscal year.

Our goal ought to be to collect as much of these owed tax revenues as possible without unduly burdening those taxpayers who are doing their dead level best to comply with the law, which I believe is really the vast majority of taxpayers of our country.

I was with a group of people yesterday and said, "How many are paying your taxes?" Most people raised their hand. And I said, "I do not know about you, but it frustrates me that for those of us who actually pay what we are supposed to pay to know that a lot of people are not." And that is up to about \$300 billion, and that is really the size of the deficit. I think people were "enraged" is probably not too mild a word to use or too strong a word to use.

However, for any number of reasons—the complexity of the Tax Code, which is a problem, haphazard record keeping, math errors—some taxpayers unintentionally make mistakes when completing their tax returns. We have probably all done that at one time or the other.

But, on the other hand, some taxpayers knowingly cut corners, and I hope to be able to ask our Commissioner in a couple of minutes to what extent the IRS can separate these folks, the tax evaders, from those who make honest mistakes. That information would allow for even better targeting of what had been limited enforcement resources, at least until lately.

The Chairman and I agree that what we need to do is a better job of collecting the tax dollars that are owed to the Federal Government, the same way that we agree on the importance of reducing the number and amount of improper payments.

I think we have had two hearings, Mr. Chairman, in this Subcommittee to examine the fact that Federal agencies are making about \$45 billion each year in improper payments. I think that is a net number. We learned from these hearings that about \$45 billion likely is just the tip of the iceberg. I think what we have heard is that the Department of Defense's financial systems are in such disarray that we do not even know what the improper payments are. And my guess is there are some overpayments included among them.

But like improper payments, then we are probably pretty far from knowing everything we ought to know about the extent of the tax gap in this country. In all likelihood, that gap may actually be larger than \$345 billion.

While we may not know the exact size of the tax gap, we do know the impact of not better managing our country's finances. We know that every dollar wasted on erroneous or fraudulent payments means there is one more dollar we will not have that we will have to borrow from China or South Korea or Japan or Great Britain or someplace else. And the same holds true with uncollected taxes. Every dollar owed to the Treasury that goes uncollected is being replaced by a dollar from somewhere else, whether it is a borrowed dollar or a new tax dollar that is levied on a family or small business in my State or your State or in Hawaii or some other place.

I am pleased that Commissioner Everson is here with us today, and I commend him for the attention I know he has provided to this tax gap issue. Your acknowledgment of the importance of this issue and your commitment to doing something about it is both necessary and important, and we applaud you for that.

But to achieve our goal of collecting every dollar that reasonably can be collected, we are going to need a comprehensive plan for success, a plan that serves as a tax gap road map to this and future Administrations and Congress. Having a plan like that helped us in Delaware when I was privileged to be the governor of our State, and my team and I set out to turn around a State Division of Revenue that just was not getting the job done in some areas. I need to offer that the work was begun before our Administration, and I think we took it to the next level.

But after years of hard work that included the Administration of my predecessor, Mike Castle, and the DuPont administration before that, we succeeded in bringing collections of delinquent taxes up to record highs.

I love to tell this story, Mr. Chairman, and I will be very brief. We have a quality award every year in Delaware, and we honor a business that—it is like a miniature version of the national quality awards. It is named in honor of a guy named Bill Gore who started WL Gore company, Gore-Tex, and a lot of other projects. And given their commitment to quality, we named it after him. One year it could be this company, another company next, or maybe a non-profit, an occasional non-profit.

I think it was my last year as governor or the year after I left, the winner of the quality award that year was the Delaware Division of Revenue, and their job performance and their customer satisfaction numbers were in the 80s. The idea that the tax collector would win the quality award and have that kind of customer approval was really pretty amazing. And what we would like to someday be able to—for Commissioner Everson, and the folks that he leads, for you guys to win the national quality award and take on at the national scale what we were able to do on a small scale in our little State.

But while Delaware's budget is only a fraction of the Federal budget, I am concerned that some of what we did there and much of what is being done in other States to identify problems, to fix them, to improve collections and customer satisfaction at this same time could be replicated, at least in part, at the Federal level. We want to help you to do that.

Thank you very much for coming today, Mr. Chairman. We look forward to hearing from you and all of our other witnesses. Thanks a lot.

[The prepared statement of Senator Carper follows:]

PREPARED STATEMENT OF SENATOR CARPER

Thank you, Mr. Chairman, for holding this hearing. Welcome to our witnesses.

Each year, the amount of tax that is paid voluntarily and on a timely basis does not match the amount of tax owed by taxpayers for that year. The difference between these two amounts is referred to as the "tax gap."

In February of this year, the IRS estimated that the tax gap was a gross \$345 billion and a net \$290 billion in Tax Year 2001, an amount larger than the projected deficit for the current fiscal year.

Our goal should be to collect as much of these owed tax revenues as possible without unduly burdening those taxpayers who are doing their level-best to comply with the law, which, I believe is the vast majority of taxpayers in this country.

However, for any numbers of reasons—the complexity of the tax code, haphazard recordkeeping, math errors—some taxpayers unintentionally make mistakes when completing their tax returns.

On the other hand, some taxpayers are knowingly cutting corners. I hope to ask the commissioner in a few minutes to what extent the IRS can separate those folks—the tax evaders—from those who make honest mistakes. That information would allow for even better targeting of what have been limited enforcement resources.

The Chairman and I agree that we need to do a better job of collecting the tax dollars that are owed the Federal Government, the same way that we agree on the importance of reducing the number and amount of improper payments.

We've had two hearings in this Subcommittee to examine the fact that Federal agencies are making about \$45 billion each year in improper payments each year. We learned in those hearings that the \$45 billion figure is likely just the tip of the iceberg.

Like with improper payments, then, we're probably pretty far from truly knowing everything we should know about the extent of the tax gap in this country. In all likelihood, the tax gap is larger than \$345 billion.

While we may not know the exact size of the tax gap, we do know the impact of not better managing our country's finances. We know that every dollar wasted on erroneous or fraudulent payments means there's one more dollar we will have to borrow from China or Japan or Great Britain.

The same holds true with uncollected taxes. Every dollar owed to the Treasury that goes uncollected is being replaced by a dollar from somewhere else whether it's a borrowed dollar or a new tax dollar that's levied on a family or a small business in Delaware or Oklahoma.

I'm pleased that Commissioner Everson is here with us today and I commend him for the attention he has paid to the tax gap issue. Your acknowledgement of the importance of this issue and your commitment to doing something about it are necessary and important steps toward the greater goal.

But, to achieve our goal of collecting every dollar that reasonably can be collected, we're going to need a comprehensive plan for success, a plan that serves as a tax gap roadmap to this and future administrations and Congress.

Having a plan helped us in Delaware. When I was Governor of Delaware, my team and I set out to turn around a State Division of Revenue that just wasn't getting the job done in some areas. After years of hard work, we succeeded in bringing the collection of delinquent taxes up to record highs.

While Delaware's budget is only a fraction of the Federal budget. I'm certain that some of what we did there and much of what's being done in other States to identify problems, fix them, and improve collections and customer satisfaction at the same time could be replicated at least in part at the Federal level.

Thank you again, Mr. Chairman, for focusing our attention on this issue.

Senator COBURN. Thanks you, Senator Carper.

Our first panel is Commissioner Mark Everson. He is the Commissioner of the Internal Revenue Service. Prior to his time at the IRS, he was Deputy Director for Management at the Office of Management and Budget, where he provided governmentwide leader-

ship to Executive Branch agencies to strengthen Federal financial management and improve program enforcement.

Commissioner Everson, first of all, let me thank you for your service to our country. You could do something else at a higher salary, and we appreciate it. Too often it is not recognized. The floor is yours.

**TESTIMONY OF HON. MARK EVERSON,¹ COMMISSIONER,
INTERNAL REVENUE SERVICE**

Mr. EVERSON. Thank you. Good afternoon, Mr. Chairman, Senator Carper, Senator Akaka. I am pleased to be before your Subcommittee once again to discuss our efforts to increase taxpayer compliance and reduce the tax gap. I very much appreciate the continuing interest of the Committee on Homeland Security and Governmental Affairs in our work. Mr. Chairman, I applaud the efforts of this Subcommittee to bring greater transparency and accountability to government. As you know, as you indicated, that was central to what we tried to do in my OMB days, and I know that Clay Johnson, my successor, is doing that and working with you now.

I am also deeply appreciative of the work of the Permanent Subcommittee on Investigations, also a part of this Committee, led by Senators Coleman and Levin, which has been instrumental in our efforts to strengthen enforcement of the tax laws. Before making several points on today's subject, please indulge me as I make my regular plea for adequate resources for the IRS. As you may know, the House has cut the President's funding request for the IRS for fiscal year 2007, which begins next week, by over \$100 million. Action to date in the Senate has been more favorable, a little bit above the President's request, although the bill has not yet gone to the floor. I ask once again for your strong support for this vital funding. We will put the money to good use.

Concerning today's subject, I would like to make two points before taking your questions: First, a comment or two on our operations for the fiscal year ending this week; and, second, brief remarks on the summary administration plan to reduce the tax gap, which was forwarded earlier today to the Finance Committee by the Treasury Department. We have delivered an excellent operational year for 2006, both on the services side and in our enforcement activities. We have also made significant strides in modernizing the IRS.

We had an excellent filing season, maintaining levels of telephone service and, again, improving the accuracy of our responses in both accounts and tax law. The number of individual returns filed electronically has again increased, as has the number of returns processed by volunteers in partnership with the IRS. That is the program Senator Akaka was talking about, which has replaced a lot of the reduction in our preparation of returns. It has gone over the last few years from 1.1 million returns prepared by VITA volunteers up to over 2.2 million.

In terms of enforcement, although I, of course, do not yet have the final numbers, we project that enforcement revenue—and that is the money that comes in from our collections activities, our docu-

¹The prepared statement of Mr. Everson appears in the Appendix on page 45.

ment matching, and our examinations—will exceed \$49 billion as against \$47.3 billion last year. You can see this growth over the last several years is quite significant. This, as I was indicating to the Chairman before we started, is only the direct result of our activities. It does not capture the indirect effect of the fact that when we audit, Dr. Coburn, Senator Carper and Senator Akaka play it maybe a little straighter, if you will indulge my example.

In terms of modernization, we have had several successes. Our new system for updating the individual master file has processed almost 8 million returns and generated over \$3 billion in refunds. But perhaps our most significant achievement this year is the successful launch of our initiative mandating electronic filing of returns by large corporations and not-for-profit institutions. Electronic filing of large corporate returns will significantly speed the audit process and allow us to use improved analytics to better target our enforcement activities. Compliant taxpayers will benefit from prompter resolution of uncertainties, and the government will benefit by identifying and addressing compliance problems at an earlier date.

This morning, the Treasury Department delivered to the Finance Committee an outline of the Administration's strategy for addressing the tax gap. The strategy builds on efforts that the Treasury Department and the IRS have taken over the last several years to improve compliance. It focuses on seven areas: Legislative proposals for reducing evasion opportunities follow on existing proposals made in the 2007 budget; a commitment to research; further improvement in information technology; strengthened enforcement programs; enhanced services to taxpayers; reform and simplification of the tax law—the point you made, Mr. Chairman—and partnership with practitioners and other stakeholder groups. The document is intended to provide a broad base on which to build. More detailed steps are being developed as part of the 2008 budget to be delivered to Congress next February.

I know that the need to reduce the tax gap is well understood and supported both by my boss, Secretary Paulson, and OMB Director Robert Portman. I think that the strategy delivered today is an important step forward. Thank you.

Senator COBURN. Thank you. Let me ask you, would you outline for us this new strategy for the tax gap? I am a big believer in transparency and results and accountability, and what you cannot measure you cannot manage. And it is my understanding that some of this new program is to put into place key metrics so you can know what the problem is.

Mr. EVERSON. Yes, sir. I agree, first of all, entirely with your assessment that you need to measure your progress and see how you are doing. This particularly comes into play in the research area. It is something we talked about last October when we were talking about the tax gap research at the time before it was finalized.

What we are going to be doing here is definitely giving a sharper focus on research. We want to update as an example the 2001 study to which Senator Carper referred. We are currently working on 1120S returns, but we want to circle back and do more work on individuals and look at not just the enforcement issues, but also

what was referenced in terms of the impact on service delivery channels.

So part of that effort over the coming months is to return the targets that would be associated with each of these seven areas, and they cover a broad range of topics. Some of these are difficult to quantify—the impact of new systems, as you can imagine, what are you going to get for those, just updating the infrastructure. But we are going to do our level best wherever we can to have hard and set goals.

What I would ask you, to the Senate and to the House, though, is that clearly we are helped in defining reasonable goals if there is stability in the system. All the constant changes to the system make it very hard to neutralize the effects of the moving parts and to understand what is really happening. So the degree to which we can calm down the Tax Code, that would help.

Senator COBURN. One of the questions as you go forward and looking at this and re-looking at—and having the measurement of the tax gap is this idea that you cannot attribute what you collected to past years in terms of the tax gap. Why can't we? If the tax gap is \$348 billion and you are going to collect \$52 billion, but you do not know if that was for 2001 or for 2000 or 1999 or 1998, why can't we have a metric that applies that so that you can actually eventually measure what you are doing?

In other words, the application of collected monies against the tax gap, why can't you apply those in the year in which they were a gap rather than against the year that you see the gap?

Mr. EVERSON. If I understand your question, I think we do that. What we said with the study was that there was a gross gap of \$345 billion for tax year 2001, and that over time we expected, based on that study and other things that we knew, to get back \$55 billion.

Now, if you would put that chart back up¹—there are two ways we are going to get after this problem, sir. We are going to bring down that gross number through better compliance up front, and then we are also going to be bringing up the reduction number.

We have already done that to a certain degree because through better collections and more examinations, that \$55 billion number, if you took that on a steady state year after year, would already have increased because of this piece. Because there are two components in the \$55 billion: There is our enforcement efforts, and then there is the money that just comes in over time because you strike an arrangement with us for payment over time or you just paid late.

Senator COBURN. OK. My key point is that of that \$49 billion enforcement revenue, how much of it was due this year, in 2005's returns, versus how much was due in 2000 versus—

Mr. EVERSON. Yes, you have to spread that out. We would have to analyze that for you.

Senator COBURN. But my point is if you are ever going to measure performance against the tax gap, here is the gross tax gap, here is what we are doing against it, if you do not do it against

¹The chart referred to appears in the Appendix on page 48.

the year in which it was supposedly owed, you are not going to have an adequate metric.

Mr. EVERSON. I agree with that.

Senator COBURN. All right. What percentage of individual returns now are filed electronically?

Mr. EVERSON. This year, it is in excess of 50—about 54-point-something percent.

Senator COBURN. Fifty-four percent.

Mr. EVERSON. Yes.

Senator COBURN. And do you foresee that is going to grow?

Mr. EVERSON. That I believe will continue to grow, yes, sir. Now, there was a mandate to bring that up to 80 percent. It was, I think most observers would suggest, rather arbitrary when it was set. I think it had a very beneficial impact, though, on the whole system because the organization and others have pushed towards that.

We are a champion of electronic filing. I think that obviously it is better for the system, better for the government, and certainly better for individuals as well.

Senator COBURN. So one other point that you made was that if we keep changing the Tax Code, that makes enforcement even more difficult, both in terms of your ability to measure and institute the changes on the enforcement side, but also for those that inadvertently file wrong because the law has been changed.

Mr. EVERSON. I think that is absolutely true. It goes hand in hand with complexity. When I talked with the tax reform panel, which was referenced earlier, back in March of last year, they asked me what were the areas you could work on if you just took an incremental approach. Look at all the credits you get for education and things like that. There is just so many different overlapping kinds of programs. It is very hard to know what to do if you are an individual. As was indicated, the practitioners see things slightly differently, depending on the fact circumstances. Simplification would help both the taxpayer and the government, sir.

Senator COBURN. OK. We are going to have in one of our panels, we are going to be talking about tax expenditures today, both at my request and the request of Senator Lautenberg. How big of a problem do you see that one? How much does it complicate your job? The largest tax expenditure, by the way, is for health care in this country, and several others that most people would agree are socially good investments to create certain behaviors. How much of a difficulty is that? And how much of this is large versus how much of it is small? How much of it is very small in terms of both the numbers and the impact that have been written into the Tax Code as tax expenditures? And what kind of problems does that cause you?

Mr. EVERSON. I think what you are getting into tax policy questions, really, as to how the Code is constructed and what our Nation chooses to subsidize.

There can be enforcement ramifications on this. An example is we testified and wrote quite clearly that the manufacturing provisions in the Jobs Act were going to cause us great enforcement issues. So it gets down largely to this question of complexity, and that word over there, your first word, “transparency.” If things are

not transparent, then any expenditure or any policy choice is just an awful lot harder for us to deal with.

Senator COBURN. All right. Thank you. Senator Carper.

Senator CARPER. Thanks, Mr. Chairman.

One of the things we worked on in Delaware—and I am sure other States did, too—at the State level was to figure out what we could do to make sure that folks who had an obligation to the State of Delaware, a tax obligation, whether it was personal, corporate, or otherwise, that they met their obligation. And we would do that through our own employees within the Division of Revenue, and occasionally we would contract with a private firm to do that work for us.

We tried to be sensitive to the needs for protection of confidential information and to make sure that we did not simply ignore the needs of having State employees do the work within the Division of Revenue and to train them and give them the resources, technical and otherwise, that they needed.

My recollection is that about 10 years ago there was an effort at the Federal level to use private sector resources for debt collection by the IRS. My recollection is it did not go well, and I know that the IRS is trying it again, trying to do it this time, but differently, to operate on the lessons that we learned from the misadventures of a decade ago.

I would like for you to talk a bit about that, what we learned and what we are doing differently. I understand that the firms that you hired to do this work, get to keep anywhere from 21 to 24 cents out of a dollar. I understand that about 25 cents out of a dollar that they collect comes back to the IRS that you can use to hire more people to do the work, to have better technology to enable your folks, to empower your employees to do the work. And I want to make sure that 25 cents actually does come back through to the IRS and that you are able to increase your resources and improve your ability to collect taxes.

Just talk a little bit about that whole thing, if you would.

Mr. EVERSON. Sure. Certainly, sir. We have commenced with that program. Earlier this month, we sent forward about 11,500 cases to the contractors. Already we have received in, I am told, over half a million dollars in cash thus far from 250-some-odd taxpayers. These are cases that we would not be working. For 4 years, we have not received the funding that we have asked for from the Congress. The budget scoring rules, you would be throwing money at us if projecting an increase in our appropriated resources would also show an increase on the revenue side from the enforcement revenue and the indirect effect we get.

So I have freely acknowledged, sir, that it is more costly, because of this percentage that the contractors would keep, than it would be were we to do this work ourselves. I would say to you, though, that even if you gave me more money to allocate within the IRS, I would not necessarily use it all on collections. We have to run a balanced program. That includes our work on charity and a host of things.

Turning to the substance of what happened in 1996 versus now, you are entirely correct; I do not think that program was well run. We were not, as I would say, deliberate in our case selection to

make sure that we were giving the contractors cases with a reasonable prospect of collection. We have been pretty careful there this time. We are working very—we have had, as you can imagine, some start-up issues, but we are very closely monitoring what they are doing, making sure that they are following the law and that they protect taxpayer privacy and rights. And thus far I think it is off to a good start.

So we are going to monitor it. I know you will hear from Mr. George afterwards. He is the Inspector General. He is all over this, and we are very accountable, I would say to you, on this program. But I am cautiously optimistic that it is going to supplement and bring in more money and help us. But if there are any warts or problems with it, we are going to be very transparent about it and make whatever adjustments we have to do.

Senator CARPER. Good. It is important to me—I cannot speak for the Subcommittee, but it is certainly important to me that the 25 cents out of that dollar that we are talking about that comes back to the IRS is—that we know how you are spending it.

Mr. EVERSON. Yes, I neglected to mention that, but this will be good for us in terms of building our infrastructure and making sure that we are addressing the collection issues.

I want to mention one thing. We actually did get an award, Senator. We got Points of Light Foundation Award.

Senator CARPER. Was it the Delaware quality award?

Mr. EVERSON. No, it was not, but we got the Points of Light Foundation Award, the first time a government agency got that award, a year or two ago for this volunteer program, the partnership we have. Our partnership organization works with others to get support for our activities. So we are not totally in the doghouse on this.

Senator CARPER. We want to make sure you earn some more awards as well. Well, let's stay in touch on this, and we will see how it goes.

I want to talk a little bit about the capital gains tax gap, and we are going to have a witness or two later on to explore that with. The Chairman and I have been working a little on it with Senator Evan Bayh.

Mr. EVERSON. Yes.

Senator CARPER. He has championed legislation, along with some others, to try to make sure that the tax gap that exists with respect to capital gains is somehow narrowed.

Any idea what that capital gains tax gap might be these days?

Mr. EVERSON. The number that I recall is something more than \$10 billion for 2001, which 2001 might have been a difficult—you have got to go back and say what year are you measuring, and if you recall, the markets reached a peak in 2000, so maybe that is hard to know at any one time whether that is a good number or a bad number.

As a general rule, if you will indulge me for a second, where we have visibility as to data or facts, compliance is very high. Wage reporting, the non-compliance on wages is about 1 percent. You are not going to cheat on how much money you make as a Senator. We know that.

Senator CARPER. You do?

Mr. EVERSON. Yes. If you are going to—despite the rumor, there is some cooperation between the Executive and Legislative Branches, and you send over that material to us. But if you look at wage reporting, there is no problem on that. We know what wage earners make.

If, on the other hand, where there is little or no information reporting, non-compliance is much more dramatic. This gets back into that component of the tax gap map we talked about last year, where underreported business income for small businesses is 50 percent.

Senator CARPER. Fifty percent.

Mr. EVERSON. Now, we have made some proposals in the 2007 budget, one of which is a modest but, I think, important proposal, to get credit card reporting on gross receipts. That is a starting point. We have one of our five legislative proposals enacted earlier this year. It actually reflects the work of the Permanent Subcommittee on Investigations and the hearings we have had on contractors, Federal contractors.

We will look at the proposal you are referencing. It is just the kind of thing we are looking at now as one of the issues that I mentioned in terms of the legislative proposals to address non-compliance. So that is in the hopper.

What I really would counsel you is if the Congress could make a downpayment by getting that credit card reporting proposal done, it would really show that there is a stomach to do some of these tough things. Because anytime you do one of these, you very much find that out of the woodwork come a lot of people who say we do not want to do something like that.

Senator CARPER. OK, good. My time has expired. Are we going to have another round here?

Senator COBURN. Yes.

Senator CARPER. Great. Thanks.

Senator COBURN. A couple of things. First of all, in terms of capital gain reporting, every brokerage firm I know right now has to report a Form 1099 on dividends, has to report a Form 1099 on interest. Correct?

Mr. EVERSON. Yes.

Senator COBURN. And they have the data on capital gains. And if they do not have the data, they can put zero, and so the gain is the total thing, and it is up to the taxpayer to prove what their basis is.

Mr. EVERSON. Let me respond to that. People change brokerage accounts, and the basis needs to shift over. I think that, clearly, going forward you could establish this on a going-forward basis.

I am somewhat sympathetic to the complexity going back with splits and everything else and changes of accounts. It would just take a while to get it fully—

Senator COBURN. Yes. I am not sympathetic at all. I have to do it every year for my taxes, and if it was split I have to figure it out. And the fact is that the onus is on the taxpayer to report their basis.

Mr. EVERSON. Yes.

Senator COBURN. The onus is not on the IRS to prove their basis. And so I think what Senator Bayh is on is great. It will not require

significant equipment. It is one other slip for each account based on capital gains, and I think it is something we should do, and I think that we are going to have testimony that is, at a minimum, \$25 billion, not \$10 billion.

I want to go back to the tax gap for a minute because we are going to have testimony from your own IG that suggests that this tax gap is larger than what we are reporting. Why do you think they think that?

Mr. EVERSON. Well, there is growth in the economy. I think we did a good job of updating and estimating the gap for the individuals. We did not look at the underreporting gap as to corporations. That is the principal area.

Now, I say that knowing that is a very hard thing to get because of the nature of the population, and the blunt reality is I would not allocate more resources into that corporate—the box there with the \$30 billion. I have said maybe it was understated by a factor of half—I would not be allocating more resources into that than what I was already doing within the range of resources that I was getting.

Again, we have given very high priority to high-income individuals where we have doubled the number of audits over the last several years, and we have brought back the corporate work, very much so. I think we are seeing some positive effects on that.

So, to me, the real importance of the study is to get the update and make the allocation decisions, to use it to make the sensible decisions on what lines you are looking at on the return.

Senator COBURN. Where do you get the greatest return for your investment in assets?

Mr. EVERSON. Well, right now it is right over in individual, and if we go to the chart, the detail on the visibility, that shows some \$68 billion based on that study, that is the underreporting of income by individuals and it is unincorporated businesses. So, clearly, I think we have made some headway on high-income individuals, and we have made some headway on—this just shows that out of that—remember the chart that showed the \$110 billion where you had low visibility? This just analyzes that and says you have \$68 billion on Schedule C income. That is an individual who has a business that they are running and they are not incorporated. That means we are understating that income.

So, clearly, there is a lot of money to go after there. We would be strengthening our oversight in that area, I would say is one of the first things we would be doing.

Senator COBURN. Senator Carper.

Senator CARPER. If I may, I want to go back to the legislation that Senator Bayh has introduced and we have cosponsored. I think it is called the SMART Act. If you would, give us some of your thoughts on the proposal to the extent that you are familiar with it. I just would like to hear more about how you feel about it.

Mr. EVERSON. Again, I think that we were accused of being rather too modest in the five proposals we put forth in the 2007 budget. But I can only tell you the storm of criticism we got, particularly from the small business community, as to the additional burden we

seemed to be creating. I believe that what we have done is we have tried to be very targeted so that we do not increase burden.

As an example, I am not proposing additional withholding. The Administration is not going there. Some have suggested that. So what we do want to do is craft proposals that can be dealt with, with the least amount of burden. I agree with the Chairman that the big companies who are handling these brokerage outfits are much better able to make that kind of an adjustment.

So we are actively looking at that proposal. We are working with OMB, the Treasury, and the IRS. We have a group that is refining our proposals now. That is why the plan, the outline of the plan that we sent up to the Finance Committee today does not have all the details yet, because they are part of the budget process, both as to the funding of our IT and enforcement activities and, very importantly, the legislative proposals. What you have there, what you are championing is under active consideration, and I will carry back your support for it.

Senator CARPER. Good, thanks. One more question. I understand you said before that the IRS could close the tax gap by an additional \$100 billion without unduly burdening taxpayers. And you talked a little bit about this today, but, generally speaking, what kind of things need to be done to bring in that \$100 billion? And what kind of burdensome measures do you think would be needed to go beyond that \$100 billion figure? Feel free to repeat some things, reinforce some things you have already said, but add anything else to that that you wish.

Mr. EVERSON. Sure. The remark that I made earlier this year was that I believe from the starting point of 2001, that \$345 billion versus \$290 billion, that you could close \$50 to \$100 billion through a combination of measures—and I think those measures are largely reflected in the document we sent forward today. They include more enforcement. They include legislative solutions with more reporting, a more efficient IRS through a better infrastructure—a whole series of things that would not fundamentally alter the relationship between the government and the taxpayer. I think they would address this issue of confusion. Simplification would be in there, all the things that we point to in that seven-point proposal.

What I do get concerned about is sometimes people will throw around the idea that, well, you can just close this tax gap and then the deficit is gone and we can all be happy campers. I do believe there gets to be a point—I am not sure where that is.

Senator COBURN. Diminishing returns.

Mr. EVERSON. Diminishing returns, where you are really adding a lot of burden. That is one reason right at this stage I am not proposing more withholding. Withholding works. We have wage withholding. But I hesitate to ask for that.

I would like to see us get that \$50 to \$100 billion first and assess as we go, do as the Chairman suggested, get more research to get a better fix on an ongoing basis of the progress we are making. I have my Director of Research here. If you would nod and say, “Amen,” it would be useful for me. I am pressing him to get regular updates, not just these big projects every 4 or 5 years.

I would like to answer that question in probably more detail a few years down the road once we have already captured the \$50 or \$100 billion.

Senator CARPER. OK. I would just observe, before closing here, Mr. Chairman, if we could collect even half of the \$300 billion, the tax gap, and if we could just reduce the improper payments or overpayments by about half, that would be another \$25 billion, put them together and that is \$175 billion. And that is certainly a bit more than the operating deficit we are going to face this year.

As we look forward to the coming decade as the boomers, our generation—I think it is our generation—start to—

Senator COBURN. You are a lot older than I am, Senator. [Laughter.]

Senator CARPER. When they start to retire and we know what impact, potential impact that is going to have on the Treasury with Social Security, Medicaid, and Medicare, we are going to need all the help that we can get if we are going to avoid piling on that debt on our kids and grandchildren. So this is important stuff.

I just want to say to you, Mr. Commissioner, and to your team that you lead, all the way to the rank-and-file folks that you lead, the work that you are doing is real important. We appreciate the efforts that are going on, on the part of everybody, including the people that work in our States and your offices in our States as well.

Mr. EVERSON. Thank you.

Senator COBURN. I would echo Senator Carper's comments, and I would also note that this Subcommittee has found in excess of \$100 billion in fraud—\$100 billion in fraud—and that is looking at less than 40 percent of the Federal Government. So if you took half the tax gap, half the improper payments, and half of the fraud, we could have the Chinese borrowing from us rather than us borrowing from them.

Thank you, Commissioner.

Senator COBURN. Our next panel, first is Russell George. He is the Treasury Inspector General for Tax Administration where he has served for 2 years. Prior to this time, Mr. George served as Inspector General of the Corporation for National and Community Service.

With him also is Nina Olson, the National Taxpayer Advocate, where she serves as an advocate for taxpayers to the IRS and Congress.

And Jay Soled is Professor of Taxation at Rutgers University and practices law at the firm of Pfizer and Soled.

Welcome to you all. Inspector General George, you are recognized.

TESTIMONY OF HON. J. RUSSELL GEORGE,¹ TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION (TIGTA), DEPARTMENT OF THE TREASURY

Mr. GEORGE. Thank you, Mr. Chairman.

¹The prepared statement of Mr. George appears in the Appendix on page 62.

Chairman Coburn, Ranking Member Carper, I appreciate the opportunity to appear before you today to discuss the tax gap and opportunities for closing it.

In 2006, the IRS updated its estimate of the tax gap based on data from the 2001 tax year. The updated information on individuals is a significant improvement because individuals comprise the largest segment of the tax gap. However, there is no new information about employment, corporate, and other taxpayer segments. With no firm plans to update the study of these segments, we will be left with an incomplete picture of both the tax gap and the current voluntary compliance rate.

Senator COBURN. Could you suspend for just a minute? Is anybody still here from the IRS? OK. I just would like for one of them to hear what the Inspector General has to say.

Mr. GEORGE. Thank you.

Senator COBURN. Go ahead.

Mr. GEORGE. Although we cannot be certain about the size of the tax gap, we do know that the three primary sources of it are underreporting, non-payment, and non-filing.

Underreporting—which is estimated at \$285 billion—is by far the largest portion and greatest challenge in closing the tax gap. Yet TIGTA concluded that even this estimate may not be complete because substantial amounts are not included in the tax gap projections. For example, the IRS tax gap projections describe the non-filing estimate as reasonable, despite the missing segments of corporate income, employment, and excise taxes. The IRS does not have definite plans to update the estate tax segment or to estimate the corporate, employment, and excise tax non-filed segments, suggesting that the non-filer estimate is incomplete, and likely inaccurate.

One recommendation that could significantly address the underreporting and non-filing segments of the tax gap involves third-party reporting. The IRS has estimated that compliance rates are as high as 96 percent when third-party reporting is involved. In contrast, self-employed individuals are estimated to report only about 68 percent of their income. Even more alarming, self-employed individuals operating on a cash basis report just 19 percent of their income.

Three years ago, TIGTA recommended that the IRS initiate a proposal for a legislative change to mandate withholding on non-employee compensation payments. Implementing such a provision could reduce the tax gap by billions of dollars. In addition, other actions should be taken to improve compliance among independent contractors.

For example, improvement is needed to address inaccurate reporting of taxpayer identification numbers for independent contractors. For tax years 1995 through 1998, the IRS received about 9.6 million statements for recipients of miscellaneous income—reporting approximately \$204 billion in non-employee compensation that either did not contain a taxpayer identification number or it had a number that did not match the IRS' records.

Withholding could be mandated for independent contractors who fail to furnish a taxpayer identification number. Implementing mandated withholding for this segment of independent contractors

could result in an estimated \$2.2 billion in increased revenue each year.

IRS compliance efforts are also limited by the lack of available information on the basis of investments, which could be used to verify investment gains or losses, as we discussed earlier. Such information reporting would allow the IRS to better focus its enforcement resources on non-compliant taxpayers.

Although individual wage earners receive a wage and tax statement—the W-2 Form—have their wages verified through a matching program, a similar comprehensive matching program for business documents received by the IRS does not exist. TIGTA has recommended that the IRS evaluate all types of business documents it receives to determine whether this information can be used to improve business compliance. An IRS study, based on TIGTA commission, found that in fiscal year 2000, business information documents report \$697 billion in potential taxable income.

Last, investments made abroad by U.S. residents have nearly tripled in recent years, growing from \$2.6 trillion in 1999 to \$7.2 trillion in 2003. To address the tax compliance challenges presented by these investments, TIGTA has recommended that the IRS make better use of foreign-source income information received from tax treaty countries.

In summary, it is unlikely that a massive change involuntary compliance can be achieved without significant changes to the tax system. Strategies have been identified to decrease the tax gap and improvements can be realized. However, the IRS faces formidable challenges in accurately estimating the tax gap and finding effective ways to increase compliance.

Mr. Chairman, Mr. Carper, I appreciate the opportunity to share my views on the tax gap and the work TIGTA has done in this area. I would be happy to answer questions at the appropriate time.

Senator COBURN. Thank you, General George. Ms. Olson.

**TESTIMONY OF NINA E. OLSON,¹ NATIONAL TAXPAYER
ADVOCATE**

Ms. OLSON. Mr. Chairman and Senator Carper, thank you for inviting me to testify today regarding the causes of possible legislative and administrative solutions. 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. 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.

To determine how to allocate its resources most effectively to increase voluntary compliance, the IRS needs to do a better job of understanding the reasons why the tax gap exists. At the risk of oversimplifying matters, let me suggest that we consider three types of taxpayers: First, taxpayers who will go to great lengths to comply with whatever requirements exist; second, taxpayers who view

¹The prepared statement of Ms. Olson appears in the Appendix on page 90.

taxes as one of many burdens they face in everyday life and who will comply only if doing so is straightforward and not time-consuming; and, third, taxpayers who will willfully seek to evade their tax obligations.

What percentage of taxpayers fall into each of these categories? It is impossible to know with precision, but available data suggests that the majority of taxpayer errors are attributable to inadvertent error rather than intentional non-compliance.

When IRS auditors conducted approximately 46,000 of individual taxpayers for purposes of the National Research Program, the auditors were asked for each issue they identified to characterize the reason for non-compliance. The results were striking. Among issues 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.

A recent GAO study on capital gains misreporting also suggests that deliberate cheating is responsible for significantly less than half of all reporting inaccuracies. We need to keep these data in mind as we craft our compliance strategies. Equally important, these data suggest the need for more refined research because classifying errors as either intentional or inadvertent does not get us very far.

Consider, for example, a taxpayer who cannot determine the cost basis of a stock or mutual fund holding he sold during the year and who intentionally reports a number that he believes represents a good-faith estimate but is likely to be wrong. That sort of intentional error is very different and calls for a very different compliance response as compared with the taxpayer who deliberately underreports his income.

In the next phase of the National Research Program, the IRS should seek to refine its determinations of the sources of non-compliance to enable it to develop a more refined and cost-effective compliance strategy.

I remain concerned that the IRS is proceeding on a course that emphasizes stepped-up enforcement over stepped-up taxpayer service. It should not be a question of service or enforcement. The IRS should integrate taxpayer service within its enforcement activities. Particularly in light of its limited resources, the IRS should focus its enforcement activities not merely on collecting unpaid past due taxes, but on trying to bring taxpayers into compliance prospectively.

The IRS could also do a better job of going where the money is, and that means the cash economy. The NRP data indicate that where taxable payments are reported to the IRS by third parties, reporting compliance comes to roughly 96 percent of the tax due. But where taxable payments are not reported to the IRS by third parties, reporting compliance drops below 50 percent. In my annual reports to Congress and in previous congressional testimony, I have offered numerous proposals to help the IRS to do a better job at combating the cash economy portion of the tax gap. Some of those proposals are summarized in the appendices at the end of my written statement, and I am not afraid to propose withholding, as some others are.

Even though the IRS can do more to improve voluntary compliance, I do believe the compliance rate will not raise dramatically unless Congress passes legislation to make it easier for the IRS to detect non-compliance, primarily through expanded third-party information reporting or withholding. And I do want to call your attention to a recommendation in my annual report to Congress about expanding reporting for—requiring brokers to track the cost basis of stock and to make it easier for taxpayers who are self-employed to make estimated tax payments, improving the offer in compromise program, and strengthening standards in the tax return preparation industry. In addition, tax simplification would help enormously. Thank you.

Senator COBURN. Thank you, Ms. Olson. Mr. Soled.

**TESTIMONY OF JAY A. SOLED,¹ PROFESSOR OF TAXATION,
RUTGERS UNIVERSITY**

Mr. SOLED. Mr. Chairman and Ranking Chairman, my name is Jay Soled. I am a tax professor at Rutgers University. I have written several papers on the issue of the capital gains tax gap. Thank you for inviting me to testify in favor of closing the capital gains tax gap and passage of the Simplification Through Additional Reporting Tax Act, aka the START Act.

Before detailing the problem of the capital gains tax gap, I would like to take this opportunity to highlight several salient points that were and were not made by the GAO in a report it issued earlier this year entitled “Capital Gains Tax Gap.”

First, what the GAO report stated is that for tax year 2001, an estimated 38 percent of individual taxpayers who had securities transactions failed to accurately report their capital gains or losses from these transactions. What the GAO report did not say is that if security ownership continues to expand is left unchecked, almost four out of every ten American taxpayers will submit income tax returns that are incorrect.

Second, the GAO report stated that these mistakes cost the government over \$11 billion annually. What the GAO report did not emphasize, however, is that this \$11 billion figure relates to individual income tax returns. As such, it probably grossly understates the magnitude of the problem. If the GAO were to have expanded the scope of its investigation to include corporate and other taxpayers such as trusts and estates, the estimated revenue loss to the government could easily exceed \$25 billion annually.

Third, the GAO report stated that the IRS is virtually powerless to close the capital gains tax gap. Without trying to paint too bleak of a picture, what the GAO report was really trying to say is that even if the IRS could audit the tax return of every single American—pity that thought—the problem of the capital gains tax gap would remain largely intact. This is because most Americans lack accurate records and the ability to track the tax basis they have in their investments.

Why is the problem of the capital gains tax gap so prevalent? Let me offer three of the most compelling reasons.

¹The prepared statement of Mr. Soled appears in the Appendix on page 126.

Reason number one: Taxpayers are notoriously lax record keepers. When it comes to record keeping, few taxpayers would deserve Oscars for their efforts.

Reason number two: Computation of an investment's tax basis can be extraordinarily complex. Consider, for example, the plight of 18 tea shareholders who, after a series of split-offs, mergers, and reverse stock splits, each now own stock in 11 different companies, each with its own independent tax basis.

Reason number three: When it comes to third-party information returns, there is no tax basis reporting to the IRS. Prior studies indicate, however, that in the absence of information returns, taxpayers compliance plummets.

The START Act offers hope to taxpayers and the government that tax basis misidentifications will be a problem of the past and that the capital gains tax gap will narrow. If enacted, the START Act would require that mutual fund companies and brokerage firms track the tax basis of their clients' investments, and upon the triggering of a reporting event, such as a sale or other disposition, the mutual fund company or brokerage firm would, in addition to reporting the amount realized, also report the investment's tax basis.

Passage of the START Act would be a boon to taxpayers, the government, and even mutual fund companies and brokerage firms. Taxpayers would have easy access to critical tax basis information. Put slightly differently, every April 15 there would likely be far fewer shoe boxes that taxpayers would have to dust off to bring to their accountants.

The most identifiable government benefit is that it could, over a 10-year scoring period, collect up to an additional quarter of a trillion dollars of revenue. That number bears repetition. That is a quarter of a trillion dollars' worth of tax revenue without increasing taxes.

Insofar as mutual fund companies and brokerage firms are concerned, around tax season no longer would their employees who staff telephone and offices be besieged by clients who call or stop by to make tax basis inquiries.

My biggest complaint with the START Act is that it does not go far enough. More comprehensive reforms such as tax basis simplification measures are probably required to narrow the capital gains tax gap even further. So, from my perspective, the START Act is just that: A starting point that should immediately be put into place.

In closing, Senators, before you ask me any questions, please allow me to take this opportunity to ask a question of each of you. Do you know the tax basis you have in each of your investments? Assuming you do not, then you should recognize the importance of the START Act and the need for its immediate passage. Thank you.

Senator COBURN. Mr. Soled, to answer your question, the answer is yes, I do.

Mr. SOLED. Very impressive.

Senator COBURN. I happened to be an accountant before I was a doctor. [Laughter.]

So it made a big difference.

I want to ask all of you to respond to this and just give me a—does everybody agree that one of the ways to increase compliances is simplification?

Mr. GEORGE. Most definitely.

Ms. OLSON. Yes.

Senator COBURN. And do you, Mr. Soled?

Mr. SOLED. Absolutely.

Senator COBURN. And would you agree that there is almost a linear relationship between the more we simplify, the more compliance we get?

Mr. GEORGE. Yes, Mr. Chairman.

Ms. OLSON. Ah, yes.

Senator COBURN. That was a quasi yes, Mr. Soled.

Mr. SOLED. No hesitation in my voice. Yes.

Senator COBURN. The simpler we make it. Are there things in your mind—

Ms. OLSON. Sir, could I clarify? I mean, you could simplify things by telling everyone they have to pay a flat 50-percent tax, and you might end up with increased non-compliance because you have made it simple.

Senator COBURN. I agree. But for the Code that we have—

Ms. OLSON. Right, yes.

Senator COBURN. Each of you have testified on things that you think need to change. What I would like to just say, based on we have what is highly probable, a \$450 billion tax gap rather than a \$350 billion tax gap. In order of priority, what are the first three things that should change?

Mr. GEORGE. Well, third-party reporting, there is no question about it. I cited the figures of individuals, 90-plus-percentage, versus those operating on a cash basis who do not have third-party reporting, I mean under 20 percent. The lack of tax compliance data, the NRP was a good first step on the part of the IRS, but it was only a first step. There is so much more information, as I noted in both my oral and written testimony, that is needed in terms of the corporate and other aspects of it. And then, lastly, unreported income, I mean literally if we were able to institute the withholding, especially for the independent contractors, that would make such a difference.

Senator COBURN. OK. And you do have communication with the researchers at IRS? They do read your reports?

Mr. GEORGE. We hope so.

Senator COBURN. Well, but I am asking, do you have one-on-one communication with the gentleman that Mr. Everson referred to in terms of working with them—

Mr. GEORGE. Yes.

Senator COBURN [continuing]. And trying to massage what can we do here in terms of measuring so we can manage?

Mr. GEORGE. Yes, we do, Mr. Chairman.

Senator COBURN. OK. Ms. Olson.

Ms. OLSON. I would have to say that if I would go to the cash economy first and look at expanded information reporting. The proposals that I have made about estimated taxes, making them easier, like a monthly payment coming automatically out of accounts so people who want to comply but cannot quite save to pay in those

estimated taxes quarterly. And then instituting some kind of a back-up withholding requirement on independent contractors who have been——

Senator COBURN. Proven to be non-compliant?

Ms. OLSON. Proven non-compliance, exactly, so that you have 2 or 3 years where they have not been able to pay. And the whole idea of that would be you get their attention and then you say to them, OK, now go into this estimated tax payment on a monthly basis, map it out a year in advance so we know you are going to make payments and, go and sin no more, and now we will work on your back liability. So sort of changing behavior.

On simplification, I believe Congress has to act on AMT, which is not just a current problem right now, but as you go to 2010 and 2012 and you see 33 million taxpayers being pulled into the system, that is going to increase non-compliance among a group of taxpayers who are currently compliant.

Senator COBURN. It is also going to be the very wedge pressure that we have to get simplification.

Ms. OLSON. Tax reform, exactly. And the third point would be additional research. We have to understand what causes taxpayer behavior.

I am sponsoring a research thing right now, a study right now, to look into taxpayer behavior, and one of the things we are looking at is why taxpayers—for example, looking at not just taxpayers, but why people stopped smoking, the non-smoking campaign. Why were we able to change behavior of the public over a period of time? And how can we change behavior about compliance with taxes over time?

Senator COBURN. Mr. Soled.

Mr. SOLED. Three ideas, and these are akin to what you just heard. First, we might look to expand information returns.

Here is an idea that you might also consider. Second, the promotion of credit cards and debit cards so that we could have people, in lieu of using cash to pay their plumbers and pay their painters, they would turn to using credit cards and debit cards, and we could almost think of perhaps a government program that would offer a rewards program akin to frequent flyer miles for people who use their credit cards and the like. I know that might strike some as being radical and strange, but countries like Mexico, I understand, are instituting such a program.

And third, another thing that we might consider that I understand other countries have done that would be interesting is perhaps every 5 years to change over our currency so that people like Mr. George was referring to who have investments overseas, all of a sudden they have to be forthcoming, or less they might risk losing their currency. So, some different angles that other countries—we might want to look at what some other countries have done to close their tax gaps, and maybe in some instances where they have been very successful, use that as a model.

Senator COBURN. OK. Mr. George, have you looked yet at the utilization by the IRS of the private collections, and have you started looking at that and watching that? What are your comments on that?

Mr. GEORGE. Well, we are in the process of reviewing that, Mr. Chairman. Just as background, over 10 years ago I was the Staff Director for Congressman Steven Horn of the Subcommittee on Government Management, Information, and Technology, who took a very strong interest in this subject matter, pushed the Ways and Means Committee to develop that pilot that, as he stated publicly, was set up to fail. It did fail, and it cost more than the amount it generated in revenue, in collections.

So when I first started this position, I indicated to my staff, as well as to the Secretary and others, this would be a top priority for me. So we have been very engaged in terms of working with the Internal Revenue Service and their preparation to establish this program, and it is too early for us to give a complete assessment as to its benefits.

Senator COBURN. OK. Senator Carper.

Senator CARPER. I am just sitting here thinking what a good hearing this is, Mr. Chairman, and we welcome each of you. Thank you for coming, for testifying, and really it is kind of like keying off of one another and reinforcing what others are saying.

One of the witnesses—I do not recall who, but one of the witnesses—maybe it was Professor Soled who said—I think you talked about what other countries have done and show how they are narrowing their own tax gap. Who said that? Who mentioned that?

Mr. SOLED. I just did.

Senator CARPER. Yes, OK. Take just a minute and let's just focus on that, what are some other countries that could be held out as best models in terms of reducing their own tax gap? And the second half of my question is the States, the 50 laboratories of democracy? Some of them do a pretty good job on their own tax gap. But what are some States, if you are aware of any States, that have done a particularly good job? And what can we learn from them?

Ms. OLSON. Sir, in the United Kingdom, I went over and did some consulting with the United Kingdom last spring and their tax system, and one of the proposals—one of the programs that they have that they instituted with the construction industry, which is notorious for cash economy, is that they have had something for the last 30 years called a "Compliance Certificate," and they have told that individuals who are self-employed in the construction industry, the employers or the contractors will have to withhold a particular percentage on their independent contractors unless they get a Compliance Certificate from the tax authority that says to the contractor this person is compliant with their taxes, whether it is an installment agreement or whatever, and you do not have to withhold.

And I really like that proposal because it puts the incentives in the right place. It makes the contractor want to—it is easier for them to hire compliant taxpayers as subs rather than people who are hiding out from the IRS. And it helps—it gets them working with the tax authority to get these people in compliance.

Senator CARPER. That is good.

Ms. OLSON. So I have recommended that procedure. What I have recommended to the IRS about working with the States is that the States have an enormous amount of information, if you just keep working on the cash economy through State business licenses,

where people who are contractors or hairdressers or lawn care people, they have to get a business license. And States and localities really enforce that because it really is their revenue stream. The people have to give their Social Security numbers and their employer identification numbers in order to get that, and if we could work out arrangements with the States to just do data matching, does this person who has a construction license show up in our tax system, or are they truly in the cash economy? Then maybe we should go pay that person a visit or at least send them a letter, and do it jointly with the States.

Senator CARPER. Good. Other thoughts? Those were excellent.

Mr. GEORGE. Senator Carper, I would just note that, first of all, I have to be careful because of the restriction on addressing tax policy, too, as the Secretary has delegated that authority within the Department to the Tax Policy Division.

That stated, there is no question that a good example would be what California and a few other States recently did with tax shelters and extending the amount of time that tax revenue entities had to review those, which some perceive to be abusive. They have a longer time frame than does the Federal Government in terms of the ability to go back and to examine it. And when you consider the complicated nature of many of these schemes, to put it diplomatically, a lot of time is needed, and in many instances, the Federal Government just does not have the resources with which to do it on a timely basis.

Senator CARPER. Good.

Professor Soled, what are some countries or maybe some States that we might hold out as models? We have heard a couple good ideas here.

Mr. SOLED. I cannot point to any particular States, but I just want to emphasize, if I could, the importance of your Subcommittee and what it is doing, because when people focus on the issue of the tax gap, what I think they fail to understand is that so many States piggyback off the Federal Government and what shows up on a Form 1040 and a Form 1120, they seem to forget that whatever you guys do and the importance of your work, that effect carries over onto State income tax returns. So whatever the tax gap is and the magnitude—and we are all fearful of what it might be—it is that there are billions of dollars that go uncollected because the Federal Government is not doing its job in terms of its collection.

So I think you can add, by a factor of about 20 percent to the Federal tax gap what the State tax gaps are, just because the work that—like I said, this piggyback effect. So I cannot point to any particular States, but I will say this: That, in general, States do some—are fairly effective in what they do in terms of getting people out there and doing perhaps more face-to-face audits. That has just been my experience, at least in New Jersey.

Senator CARPER. The Chairman asked a question a bit earlier. I think he asked you to give him your top three sort of like suggestions, and let me just ask you the reverse of that question or the inverse of that question, maybe two or three things that we ought not to do, not just we as two Senators, but as a Congress. What would be wise to avoid doing?

Mr. GEORGE. Well, there is no question that if certain policies were adopted that requires complete disclosure of every financial interaction—or transaction, rather, that one engaged in, you could in theory ensure the IRS the ability to collect or at least know what it needs to collect from taxpayers. But given the burden that would place on the taxpayers, I do not think anyone would advocate making that type of drastic policy.

Ms. OLSON. I think that we should not plow forward on the assumption that enforcement of a one-size-fits-all type approach—I talked in my testimony about unintentional versus deliberate errors, and I believe that those two buckets are much too clunky, that we need to even refine that even more.

You have people who make errors because the procedures are just too burdensome. You have people who make errors because they do not understand what we are asking them to do. Those are two different things. We have people who make errors because their preparers have suggested that it is OK to do this or are acting as facilitators. And then you have the truly asocial taxpayers who are making not errors but are actively evading. And each one of those types of non-compliance require a different approach. And if you take the wrong approach, if you just use the same audit or the same collection action for each one of those people, you are going to run the risk of converting people who are really trying to comply into angry taxpayers who are going to say, “The IRS treated me badly, and I am now going to do everything I can to not comply.” And you will have really done something terrible there.

I really want the IRS to be more nuanced and not just sort of plow ahead.

Mr. SOLED. I would be careful about giving taxpayers too many options, and let me just give you the example with respect to reporting of tax basis. Right now taxpayers can use several different methods to report their tax basis. They can use the specific identification method. They can use first-in, first-out. They can use averaging. I mean, you give too many taxpayers too many options, and it becomes very complex both to taxpayers and, as complex as it is to taxpayers, it becomes that much complexity to the IRS to monitor compliance.

So I would just be careful about trying to be too nice to taxpayers. I do not mean this in a harsh way to taxpayers, but in trying to be too kind to taxpayers, you may overdo a good thing.

Senator CARPER. Mr. Chairman, I would just observe that a couple of our friends, John Breaux and Connie Mack, were asked by the President to lead a review of our Tax Code and give us their thoughts, along with, I guess, the Commission that they led, as to what we might want to do differently. And they floated their ideas, and I do not think much has happened with respect to those ideas.

Obviously nothing is going to happen this year. We are going to have in the next couple of years a lot of focus on folks running for President, people wanting to lead the country, and they are going to be talking about what they would do differently, better or worse. And I think we will have an opportunity probably during the course of a Presidential campaign to consider changes we might want to make in our Tax Code. And I think what we are hearing today, keep it simple would be a good principle to underlie that.

But somebody is going to be elected President—I don't know if we are going to do major tax reform in the next 2 years, but somebody is going to be elected President in 2008, and then they will have an opportunity to lead us in a new direction.

I do not know that we will have an opportunity in the next year or two to do as much as we might want to do on this front. But to the extent that we can tie the debate on tax reform, which I think will flow from a Presidential campaign, into the kind of efforts that we are discussing here, we will do our country, I think, a big favor, a big service.

Thank you.

Senator COBURN. Thank you.

One of the reasons you have not heard much, I think, on that Tax Commission is they filtered it with politics instead of policy, and they said not what was possible, but they said what might be politically possible, rather than how do you fix the problem and then go sell it to the American public. And when you do that, the American public gets shortchanged.

I want to thank each of you for your service. Professor, thank you for coming. And this panel is dismissed.

Thank you very much.

Panel three consists of Stephen J. Entin. He is President and Executive Director at the Institute for Research on the Economics of Taxation, an economic public policy research organization based in Washington, DC. He served as the Deputy Assistant Secretary for Economic Policy at the Department of the Treasury during the Reagan Administration. Prior to his time at the Treasury, he served as staff economist with the Joint Economic Committee.

Also with us is Jason Furman, Visiting Scholar, New York University. He is also a Non-Resident Senior Fellow at the Center on Budget and Policy Priorities. He previously served as Special Assistant to the President for Economic Policy in the Clinton Administration.

And, finally, Neal Boortz, co-author of "The FairTax Book" and nationally syndicated talk-show host.

Welcome to each of you. Mr. Entin.

TESTIMONY OF STEPHEN J. ENTIN,¹ PRESIDENT AND EXECUTIVE DIRECTOR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. ENTIN. Chairman Coburn and Ranking Member Carper, thank you for inviting me to testify on the issues of the tax expenditure database and its relationship to the issue of tax transparency.

What is tax transparency? Tax transparency is an attribute of the tax system. It does not mean publishing everyone's tax returns. People should not be afraid of that.

Transparency means adopting a tax system based on sensible principles that are widely agreed upon. It would measure income correctly and have simple, clear calculations of tax liabilities and would treat all income and all taxpayers alike. Clarity and simplicity would put to rest suspicions that some people were not pay-

¹The prepared statement of Mr. Entin with an attachment appears in the Appendix on page 131.

ing what they should due to deficiencies in the Tax Code as opposed to enforcement problems.

Each taxpayer would have to apply that set of tax rules to his or her income and pay the resulting tax liability. The tax returns and tax payments, however, would not be made public. The tax law and tax rules would be transparent to everyone, not the incomes, business arrangements, and tax payments of the taxpayers.

Section 6103 of the U.S. Code requires that the IRS protect taxpayer privacy, and the IRS has very strict policies to enforce that legal mandate. The raw information in the master tax file is available only to employees of the IRS and the Treasury's Office of Tax Policy and to employees of the Joint Tax Committee.

Tax file data that is shared with other Federal agencies or the public is shared only in a form that has been organized in large enough subgroups to protect the identities of the taxpayers.

Would a tax expenditure database, akin to the earmark database, improve tax transparency? I do not think so. A list of tax expenditures, numbers of users, and dollar amounts are already published by the Treasury, the Joint Tax Committee, and the Ways and Means Committee in print and on the Web. The Treasury tables are also presented in the Federal budget.

The estimates are obtained from the master tax file by means of a sample of about 200,000 returns out of about 130 million individual returns and 20 million business returns. Creating a tax expenditure database by examining all 150 million returns would be difficult and expensive. A more detailed presentation would run into serious privacy concerns, could thereby damage voluntary compliance by taxpayers, and would involve greatly expanded reporting requirements for individuals and businesses.

The aim of a database would be to highlight tax provisions that are clearly unwarranted favoritism toward a small group of taxpayers. Under informal Senate Finance Committee and House Ways and Means Committee rules, such "rifle shot" tax breaks are currently supposed to be identified and disallowed by the Committee Chairmen before the bills are voted upon. Once enacted, it is difficult for the IRS to determine which taxpayers are using the provisions. It really is the responsibility of Congress to avoid creating such provisions in the first place.

A more basic question is: What is a tax expenditure? It is defined in the law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." That is easy to say, sort of, but hard in practice to deal with.

What is or is not a tax expenditure depends critically on what is regarded as regular treatment under the tax system. The Analytical Perspectives section in the Federal budget reports tax expenditures under two income tax baselines. And since the fiscal year 2004 budget, it has also provided a list of tax expenditures measured against a neutral or consumed-income tax concept.

In the pure Haig-Simons income tax, there would be no double taxation of corporate income. Anything now listed as a corporate-related tax expenditure would disappear, and the corporate tax itself would be a "negative" tax expenditure. Capital gains and the

imputed income from owner-occupied housing would be taxed as accrued. Deferral of the tax on capital gains would be considered a tax expenditure. However, failure to adjust for inflation, as in the current system, would result in “negative” tax expenditures on the inflation component of capital gains, interest income, and depreciation, and a tax subsidy on interest deductions.

The current income tax does not follow the Haig-Simons definition of “income.” They report tax expenditures under the “normal tax baseline” and the “reference tax law baseline.” Each accepts the corporate income tax and the deferral on unrealized gains as normal, and not as a negative or a positive tax expenditure. The reduced tax rates on dividends and capital gains that currently offset some of the double taxation of corporate income are not considered tax expenditures by the Treasury and have not been since 2005.

The normal baseline counts the lower than maximum corporate tax rates and accelerated depreciation and the tax exemption of cash welfare payments and the deferral of foreign-source income as a tax expenditure while the reference baseline does not.

The personal exemption and the standard deduction are considered normal. The exclusion of income from owner-occupied housing is not considered a tax expenditure. The exclusion of health care premiums on employer-provided health insurance is considered a tax expenditure. The arbitrary nature of these rules is obvious.

The differences are greater versus a neutral or consumption-based tax. Pension arrangements and IRAs are considered tax expenditures under the income tax, but would be normal tax treatment under a neutral tax system. The extra tax on ordinary saving under the income tax today would be regarded as a negative tax expenditure, or punitive tax. Investment would be expensed. Even accelerated depreciation would be a negative tax expenditure.

Treasury reports other differences under these concepts. It also reports in this section in the budget that there are many measurement issues, timing issues, behavior issues involved, and the numbers cannot simply be added because we are feeling one set of provisions would affect the revenue estimates on others. They give a lot of warnings in that chapter. It is a good one to read.

In conclusion, let me say that tax expenditures are generally fairly broadly available and accessible at the initiative of the taxpayer, much like entitlements on the spending side of the budget. They are not typically the “rifle shot” special interest benefits that would be comparable to earmarks on the spending side of the budget that have been inserted by Members of Congress. I do not support rifle-shot provisions, but generally tax expenditures are not rifle-shot provisions.

Tax expenditures are often deliberate and well-crafted offsets to the relatively heavy tax burden imposed by the income tax on income from capital. They are partial steps toward a consumption base. There is nothing wrong with moving in that direction. In fact, the income base is so detrimental to capital formation, productivity, and wages that many economists regard the neutral tax base alternatives as clearly superior.

Some tax expenditures are bad tax policy. Some are intended as social policy. Listing all tax expenditures by beneficiary, even if it

were possible to do so, would offer no guidance as to which ones ought to be repealed.

Tax expenditure provisions are part of the Tax Code. Using them is not tax evasion. The provisions are not part of the tax gap from non-compliance.

A tax expenditure database akin to the earmark and grant database is not a sound concept, nor a workable idea.

Thank you.

Senator COBURN. Thank you. Mr. Furman.

TESTIMONY OF JASON FURMAN,¹ NON-RESIDENT SENIOR FELLOW, CENTER ON BUDGET AND POLICY PRIORITIES, AND VISITING SCHOLAR, NEW YORK UNIVERSITY WAGNER GRADUATE SCHOOL OF PUBLIC SERVICE

Mr. FURMAN. Thank you, Mr. Chairman, for the invitation to address you today, and thank you very much for your legislation adding transparency to Federal spending. I would like to see the Subcommittee consider taking the next step and moving that transparency to tax expenditures.

As the GAO recently warned, although tax expenditures are substantial in size, little progress has been made in the Executive Branch to increase the transparency and accountability for tax expenditures. In particular, I would suggest that the Subcommittee consider three recommendations:

First, requiring government agencies to provide more detail about tax expenditures, including their magnitude and distribution across States, incomes, industries, and budgetary functions.

Second, subjecting tax expenditures to the same performance and evaluation processes as spending proposals, including procedural reviews that apply to outlay programs.

And, third, extending the searchable Internet database established by the Federal Funding Accountability and Transparency Act of 2006 to cover more tax expenditures, going beyond the Treasury and the Joint Committee on Taxation's current practice of listing major entities that directly benefit from targeted tax expenditures.

I will provide more motivation and detail for these recommendations, and then my written statement provides even more.

As you well know, the government allocates hundreds of billions of dollars annually through tax expenditures. If the government wants to allocate resources towards, for example, the production of \$1 billion worth of tanks, it could appropriate the money and pay a weapons supplier \$1 billion in exchange for the tanks, or it could enact a \$1 billion weapons supplier tax credit. Although our government accounting system treats the spending provisions differently from a targeted tax cut, they are essentially the same.

The same could be said if we converted the child tax credit into an entitlement program that gave \$1,000 per child or, conversely, converted Social Security into a refundable tax credit, the government accounting system would record substantial changes. In terms of the reality of our society and our fiscal system, there would be no difference at all.

¹The prepared statement of Mr. Furman appears in the Appendix on page 156.

In recognition of this parallelism, the United States has adopted a statutory definition of “tax expenditures” which is widely accepted among economists and other policy analysts. In the last budget, the Treasury listed a total of \$911 billion, nearly as much as what we spend on discretionary spending or mandatory entitlements.

If the government approves a \$1 billion spending project, it must either raise taxes or cut other spending to pay for the project. The financing choices for—or borrow money, which postpones but does not alter those choices. The financing choices for a tax expenditure are exactly the same: The government will have to raise taxes on everyone who is not specially favored by the tax expenditure or cut other spending. It is identical in terms of its fiscal impact.

Tax expenditures also raise additional concerns for fiscal policy. They create the perception or reality of unfairness, add complexity to the Code, encourage inefficient policies, reduce fiscal flexibility, and, importantly, they disguise the true size of government.

The proper measure of the size of government is the degree to which it allocates and redistributes resources. Tax expenditures allocate and redistribute substantial amounts of resources, yet they are accounted for as reductions in government revenues rather than increases in government outlays. As a result, although tax expenditures increase the government’s intervention in the market economy, in some cases warranted and in some cases unwarranted, the most common measure of the size of government records them as a reduction in the size of government.

For these reasons, tax expenditures should receive the same scrutiny as government outlays. Under current law, they receive substantially less scrutiny than spending. Tax expenditures are not incorporated into the main budgetary tables prepared by OMB and CBO. They are not subject to annual reviews, periodic reauthorizations, or other tools of budgetary evaluations.

But as you are thinking about increasing transparency and accountability for tax expenditures, you should be mindful of concerns about privacy and other issues not faced in constructing a database for government outlays.

Americans are compelled to file tax forms. They are not compelled to apply for government grants. Thus, there is an asymmetry between disclosing information about tax expenditures and information about grants. But this asymmetry should not be exaggerated. Spending also faces important privacy concerns that were successfully addressed in the Federal Funding Accountability and Transportation Act of 2006 by exempting individual recipients of Federal assistance and government employees. A similar approach could be applied to taxes. For example, entity-level reporting could be limited to business tax expenditures. This reporting could be further limited to provisions that target benefits to narrowly defined classes of entities or only entities that exceed a specific dollar amount from the tax expenditure, like \$100,000, or, say, the top 25 entities benefiting from a specific provision. It should be stressed, though, that disclosing individual tax expenditures like medical deductions or mortgage interest deductions would be a gross violation of privacy and contrary to the public interest.

In conclusion, as you move forward in your work to think about taxes, I think the most important principle to be guided by is par-

allelism to the greatest degree possible. When you tighten up the rules on spending, it creates the incentive to shift things over from the spending side of the ledger to the tax side of the ledger. That could undo a little bit of the good work that you have done, and so plugging that second set of holes I think will form an important complement to the steps Congress has already taken.

Thank you.

Senator COBURN. Thank you. I assure you we are going to tighten both. Mr. Boortz.

TESTIMONY OF NEAL BOORTZ,¹ CO-AUTHOR, "THE FAIRTAX BOOK"

Mr. BOORTZ. Mr. Chairman and Mr. Ranking Vice Chairman, I am not adept at the language of Washington. I am a reformed lawyer and a radio talk-show host. But sitting here listening to much of this testimony, I can tell you that you can work until the cows come home, and you are never going to make the American people understand even the concept of a tax expenditure. If your goal here is to make our Tax Code more transparent and to simplify it, there are, I think, some certain ways that you can go. The Tax Code today is anything but transparent. I will give you a few ideas.

On Tax Day, if you were to ask almost any co-worker or almost any friend, "How much did you have to pay in taxes this year?" the response you are going to get is: "I did not have to pay anything. I am getting some back."

Likewise, if you ask a co-worker, "How much do you make?" the most common response you are going to get is, "None of your business." But those who do choose to answer are going to say, "Well, I take home . . ." and they will plug in a figure. People do not know what they pay in taxes. They do not even know what they earn, thanks to the magic of withholding.

Now, if you are an obnoxious radio talk-show host, such as myself, you can just say, "Look, pal, I did not ask you how much you took home. I asked you how much you made."

But the message is clear here. Due to the intricacies of our current Tax Code and the withholding system, most wage earners do not have any idea where they stand in this arena.

If the path to true tax transparency is the real goal here, then the solution already exists in the form of S. 25, H.R. 25. It is called the FairTax Act. Saxby Chambliss introduced it into the Senate, John Linder into the House of Representatives. It has been in the Congress for 6 years now.

Under the FairTax, personal and corporate income taxes would be eliminated. Capital gains taxes, estate taxes, Social Security taxes, Medicare taxes, taxes on dividends, they are gone. And in the place of all of these taxes, we have one embedded national sales tax at the rate of 23 percent, which is revenue neutral for businesses, for the taxpayers, and for the government. We do not have to talk about credit card net receipts reporting. We do not have to talk about withholding on independent contractors. Those concepts become just completely unnecessary.

¹The prepared statement of Mr. Boortz appears in the Appendix on page 162.

Now, let's be clear here that this does not mean that the cost of goods and services in the marketplace go up by 23 percent. We already have—and extensive research has shown this—an embedded tax on virtually everything that we buy in the marketplace in the form of goods and services of about 22 percent, some items higher, some items lower. The embedded taxes through the competitive aspects of the marketplace, they disappear. They are replaced by the national retail sales tax.

Now, if it is tax transparency we want, consider this: Under this FairTax proposal, you go buy a \$100 toaster, the receipt you receive at the store says "Toaster, \$77. FairTax, \$23." Now, that is tax transparency. The person walks out of the store knowing exactly what they have paid. No longer would American workers lack that understanding of the effect on the Tax Code on them.

Now, when we talk about the FairTax, people say, oh, my goodness, this would be just onerous on the poor. To mention that the FairTax bill, however, has a system of rebates where no household in this country ever has to pay this national retail sales tax on the basic necessities of life, as measured right up to the Tax Code.

Now, there is a lot more in my prepared statement, but I want to mention this: The FairTax drives voters to the polls. In three counties in Georgia during the recent primary, the FairTax was on the ballot versus the flat tax. Which way would you like to reform our tax system? The national retail sales tax took 85 percent of the vote in every one of those instances.

I received letters and comments from people that said, "I would not even have voted in that primary if it had not been for the fact the FairTax was on the ballot."

One man wrote me to tell me that his wife had just had four wisdom teeth removed that morning. She was not feeling very good. She was on the painkillers. But she heard me on the radio say, "The FairTax is on the ballot in your county." She told her husband, "We are not going home. We are going by the precinct. We are going to vote on this issue before I go home."

I think there are a lot of people in Congress, Senate and House both, that would love to see an issue that would drive people to the polls like that, and the FairTax will do it.

So one more thing, very quickly, because I am 6 seconds over my time. Since I co-wrote "The FairTax Book" with John Linder, which debuted No. 1 on the *New York Times* best-seller list—and I think that is worth noting. A book on taxes debuting No. 1 on the *New York Times* best-seller list? I have noticed that there is a lot of burgeoning opposition to the FairTax idea, and in my customary fairness, I will say that people have a very difficult time raising objections to it unless they first rewrite it, as the President's Tax Reform Commission did, or they just flat out lie about it. So I would just ask in your deliberations that the Members of this Subcommittee give a quick look to S. 35 and perhaps some close attention to the letters I am sure you are getting from your constituents on this issue.

Thank you very much.

Senator COBURN. Thank you, Mr. Boortz.

I want to spend just a minute talking about this idea of tax expenditure. How did we ever get to where we used that nomen-

clature? The assumption to use the idea of a tax expenditure assumes that all wealth should belong to the government and that if we incentivize certain behaviors through tax credits or rifle shots, as Mr. Entin said, we are giving something back. What is the history of that nomenclature, Mr. Entin?

Mr. ENTIN. I think it began with Stanley Surrey, who was a professor of law at Harvard. He became Assistant Secretary of the Treasury-Tax Policy during the Kennedy Administration, and he wanted to create a method that would reveal the sort of spending nature of some tax provisions. Treasury worked on that issue through the Johnson Administration, and by the end of that, they reported out their findings. And I believe that is when the term “tax expenditures” came to be.

Treasury Secretary Joseph Barr presented the results at a hearing of the Joint Economic Committee a few days before President Nixon’s inauguration. That is the hearing which is best remembered for Mr. Barr’s disclosure that 21 people earned more than \$1 million in 1967 without paying any Federal income tax due to tax preferences. This is what ultimately resulted, I think, in the alternative minimum tax, which is a whole different issue. But I think that is the origin of the term.

Senator COBURN. I take it from the testimony we have heard from all of you, even you, Mr. Furman, that we really need to be clear about our language, and simplification—and I am really going toward simplification. Your whole goal for having transparency on “tax expenditures” is so we can have the transparency required to get the changes we need to eliminate those that are egregious.

Mr. FURMAN. That is right.

Mr. FURMAN. Certainly one should not get too hung up on the semantics. I prefer the term “tax expenditure” as it is the statutory term. Also, among economists, tax lawyers, and among a number of others, there are important conceptual parallels between them. But you do not have to accept that term or that concept to accept the idea that we should be more transparent about this. Ones that work well we should do more of or the same, and ones that do not work well we should get rid of or modify.

Senator COBURN. OK. Do we have a lot—and, again, the focus of our hearing really is not this, but do we have a lot of rifle-shot tax expenditures?

Mr. FURMAN. We have a number of them. In my testimony, I listed, for example, the Jobs Act of 2005 included a provision that “extended placed in service date for bonus depreciation for certain aircraft . . .” If that was not enough, it limited it to “excluding aircraft used in the transportation industry,” and only for things “properly placed in service after September 10, 2001.”

Senator COBURN. So that obviously was for one company’s benefit that made one airplane?

Mr. FURMAN. Correct. That is reportedly the case. You could not look in the tax law and know what company it was that received it, and that was an estimated \$247 million. You could not look in the tax law and see that, and you could not look at any Federal database and find out the identity of that company.

Senator COBURN. So if we had the Fair Act, we would not have any of that.

Mr. FURMAN. That raises a number of other tax policy issues. It does not require changing the tax base. An income tax base, a consumption tax base, a retail tax base—all of those can be simple or complicated. Those are two different dimensions, the choices of base versus the degree of complication.

Senator COBURN. But the whole idea is to simplify it and make it transparent. That is like our previous panel. They all wanted to simplify it, make it more transparent.

Mr. FURMAN. I agree with that, and I would even go one step further and say, in general, the government should be less involved in the economy at the level of tax expenditures in terms of picking and choosing winners and losers and desirable activities and undesirable activities. I think that is a measure of the growth of government, and it grows in a way that is invisible to people who focus just on the total amount of spending.

Senator COBURN. That is a very good point.

Any other comments? Mr. Entin.

Mr. ENTIN. Many of the rifle-shot provisions, such as that one, expired. In looking at the area in which it occurred, it had something to do with expensing. Under a consumed income or sales tax, you would have expensing of capital assets rather than depreciation. You need to decide on what your appropriate tax base is before you can decide whether you want to get rid of the rifle shot giving the expensing to one airplane company or expand it to all investment for all companies and all small businesses. As an economist, I prefer having the expensing and go to the sales or—excuse me, not the sales, the saving consumption neutral base rather than the income base. The broader question of what do you do all across the spectrum with something like that is one that needs to be addressed in the fundamental issue of tax reform. Until then, I would agree, we should stop the rifle-shot approach, and supposedly the Committee Chairmen are not doing that anymore since 1986. But, clearly, occasionally one of these things still slips through.

Senator COBURN. It is interesting that we penalize savings but incentivize borrowing by our Tax Code, because we charge income tax on interest earned, but we give you a deduction for interest paid.

Mr. ENTIN. I have no quarrel with giving a deduction for interest paid when the recipient has to pay tax on it. More fundamentally, the income tax says to you, if you save your money, we do not count the cost of foregone consumption as a cost to you. We sort of say we are going to tax the money before you save it, and we are going to tax the returns. But if you spend it, we have taxed it before you spent it, but we then do not tax again what you spent it on.

Now, when I eat the sandwich or watch the television, that is what I bought with my money. When I put my money into the bond, I bought the interest. I bought the future income stream. I bought the dividends. I am taxed on those again, but I am not taxed again on the sandwich or the television, except where you have a few selective excise taxes. That is the problem with the income tax. It hits income used for saving more heavily than income used for consumption—on top of which you put on the corporate tax, which we then overstate by not having expensing instead of

these depreciation allowances that do not reflect the full value of the outlay. And then, of course, there is the death tax on top of that.

That whole structure needs to be reformed in one of the neutral manners. The FairTax is one. The flat tax is another. The consumed income tax, the old Nunn-Domenici tax, the VAT—all of these are neutral taxes. Until you know which tax base you want, many of these provisions cannot be identified as a tax expenditure or not a tax expenditure.

Senator COBURN. OK. Thank you. Mr. Boortz.

Mr. BOORTZ. I was just thinking, Mr. Chairman, I appreciate your comment, very closely to the adage you get more of the behavior you punish, you get less of the behavior you reward. And our current tax system punishes the very behavior we seek more of out of the American people, rewards the behavior of free spending that perhaps we do not want in some instances.

And I would just say—and I hope that this is taken in the spirit, Mr. Entin, in which I say it, but if I could play for my listeners that excerpt we just heard about sandwiches and televisions and let them hear how taxing their labor is discussed in Washington, I would certainly win a lot more converts to my side of this argument.

Senator COBURN. Mr. Furman.

Mr. FURMAN. If I could just add one thing, and it is repeating what I said before, which is that people who think about tax reform think about two separate issues. You could have a consumption tax, exactly the type that Mr. Entin might like, and then Congress could monkey around with it and add rifle shots and it could then add really large tax expenditures along the form of tax entitlements.

Similarly, you could have an income tax and keep it really pristine and really pure. So these are really two very different issues, what you want in terms of your tax base and your tax system—it is a very important issue—what you want in terms of simplicity and complexity. And for the most part you can move sort of in either direction within either set of bases.

Senator COBURN. All right. Thank you. Senator Carper.

Senator CARPER. The last time I recall the Congress and the President attacking with some success tax simplification may have been legislation that was adopted in 1986 when Ronald Reagan was our President and I believe Dan Rostenkowski chaired the House Ways and Means Committee. I am not sure who chaired the Senate Finance Committee. It might have been Bob Dole. It may have been Daniel Patrick Moynihan. In any event, it was a divided government. But they were able to come to agreement on what I think will be a pretty tough issue to find consensus on.

Thinking back, some of you might actually be old enough to remember that, and just recall with us, if you will, the elements that enabled us to make what I think most of us would say was a little progress toward tax simplification. Think back to the elements that were in place to enable us to make a little progress. If you do not agree we have made any, then that is another issue. But how might we go about replicating that progress in the next couple of years?

Mr. BOORTZ. Senator, if I might say, that 1986 simplification of our Tax Code has been modified to date nearly 10,000 times by the Congress of the United States. That hardly fits my definition of "tax simplification." You talk about rifle shots. We even have a specific tax exemption in there for one manufacturer of ceiling fans.

Senator CARPER. No, excuse me. I want you to answer my question, if you will. My question was—somehow in 1986, in a divided government, I think we took at least some measured steps toward tax simplification. It has been, I think arguably, undone to a great extent—

Mr. BOORTZ. Absolutely.

Senator CARPER [continuing]. Over the last 20 years. But what existed then in 1986, and how might we replicate that, even if we do not go to the extent of some of the reforms that you all are talking about?

Mr. FURMAN. All right. Thank you. First of all, I would not exaggerate the degree to which it has been undone. The top marginal rate was 50 percent prior to the Tax Reform Act of 1986. The top marginal rate is well below that right now, and we are raising the same or more revenues as a share of GDP, in addition to the fact that we have added the child tax credit and a number of provisions that are very broadly supported. So I think our tax system is in greater shape today than it was in 1985, thanks to the effort of this body.

That being said, it is not in great shape, and this body really needs to return to it, and I think on a bipartisan basis is the only way, both as a practical matter and as a substantive matter that you can get it done. Basically, any tax reform creates winners and it creates losers if it is revenue neutral, and the losers in our political system tend to be angrier than the winners.

Senator CARPER. I noticed. [Laughter.]

Mr. FURMAN. There are two ways to deal with that. One is to pretend there are no losers, and some have taken that approach. They have taken a free-lunch approach, and they pretend they have a magical elixir that will cut everyone's taxes, make everyone richer, and have no trade-offs whatsoever. Every serious analyst who has ever looked at one of those free-lunch proposals has said that is not the case. It will substantially raise taxes on some people and cut them on others.

That is not an argument against it. That is not an argument for it. That is a fact we need to face in reality in evaluating proposals and a political fact. That is why the two parties working together is the best recipe, because then you may not demonize the other party for some of the losers they create and they will not demonize your party for some of the losers you create, and you all hold hands and jump together, and that is what I would like to see happen.

Senator CARPER. Mr. Entin.

Mr. ENTIN. I was at Treasury during that period.

Senator CARPER. What were you doing there?

Mr. ENTIN. I was Deputy Assistant Secretary for Economic Policy.

Senator CARPER. OK.

Mr. ENTIN. My Assistant Secretary was discussing with the Secretary how the Treasury proposals ought to go, but, of course, the

tax people did not want the economic people butting in. So let me say that the 1986 proposals that came over from the Treasury were not conducive to capital formation. They came from a career staff that was raised on the income tax and Stanley Surrey's definition of "tax expenditures." The hybrid tax system, which is partway between income and consumption bases now, and was to some extent then, had been pulled a little further toward the consumption base by the 1981 tax changes, which were gradually eroded in 1982 and 1984, and the career people were bound and determined that they be further eroded in 1986.

We raised taxes on capital substantially to lower the individual tax rates. The stock market crashed the next year, and it paved the way for the 1990 recession after two payroll tax hikes followed.

We curtailed access to IRAs. We lengthened asset lives, and had initially asked that they be indexed for inflation, the depreciation write-offs. But the Senate Finance Committee decided not to do that because it wanted a few dollars to have some rifle-shot things for some friends. So it raised the cost of buying plant and equipment instead of lowering it and turned the bill into an anti-growth bill instead of a pro-growth bill.

I would not call it reform. I would call it an anti-reform.

On the international side, it took something that was miserably complicated and made it hideously complicated. The tax attorneys were delighted.

Now, why did it happen? There was a deficit. People were nervous about it, even though interest rates were coming down, even though it turned out to be disinflationary rather than inflationary. There was a prevailing view of how the economy worked and the tax system worked that was out of line with reality. There was a frenzy. The President proposed an improvement. The old guard took over to undo reforms that had recently been made, and that was true on the Hill as well as at the Treasury.

I think we need a much broader understanding of what is and is not good tax policy before we have any more of that sort of thing going on. I think we have had a broader understanding. In the years since 1986, we have had one very good Presidential panel, which was constrained in what it could offer by a number of items in its directive from the White House and could have, as Dr. Coburn has explained, gone further had they not been constrained. But they did resurrect the notion of the consumed income tax or the neutral tax systems that were the non-income base rather than the income base. They resurrected the blueprints for basic tax reform that the Treasury wrote in 1976 under David Bradford. They made it intellectually acceptable again, and they opened up the entire debate. They have warned us: You have to know where you are going before you start down the reform road. And I think that was a very important contribution of that panel, although, again, I do wish they had gone further.

We have a deficit today, but it is coming down. We have learned now for the second time that major deficits can occur in a situation of low interest rates and low inflation. We are not as panicked as we were back then, but we do have more reason now to proceed with a tax reform. We can look around the world at successful tax reform experiences. You have the flat income taxes that were

adopted in parts of Europe. You have the dramatic lowering of corporate tax rates in the EU because they realized that it was detrimental to growth, and the substitution of a neutral tax, they chose the VAT. That is not my favorite. But they have been moving their tax codes in a direction that is less harmful to capital formation, partly because they are competing among themselves for locating capital in their countries. Ireland put the cat among the pigeons, God bless them.

We need to learn from that, and we also can learn that if you do that sort of thing, it is doable and it can improve the welfare of the general public. We will need to trim some spending to make it work well, as has been pointed out. I do not want to call it a free lunch, but there are a lot of distortions and anti-growth elements in the current system that would yield some revenue reflow. You do not have to cut spending by a dollar for each dollar you cut taxes if you cut taxes correctly. Treasury is now exploring that trade-off as a matter of fact. They should have done it years ago. The Joint Tax Committee is doing it, but in a manner I do not think is going to work well.

So this whole area of research needs to be supported and pushed.

Senator CARPER. All right. Any closing words, gentlemen?

Mr. FURMAN. I do not want to refight something that I was not present for, but the broad agreement among economists is that 1986 is a real model of broadening the base and lowering the rates. Just to appreciate the magnitude, the top rate was 50 percent. It brought it down to 28 percent.

I think Mr. Entin has his views, and I am sure all of us, if we went back, would have things that we would want to change, but that type of model, to work together, broaden the tax base and bring rates down, is on that I think is the most promising way to move forward for tax reform.

Senator CARPER. All right. Mr. Boortz, please? And I have about 1 minute to finish, so I would ask you to wrap up.

Mr. BOORTZ. One thing very quick. Yes, the 50-percent tax rate down to—what was it?—28 percent, I believe, also at the same time eliminating many of the deductions that would make that 50-percent tax rate much lower in actual basis.

Mr. FURMAN. We are talking about marginal rates, what economists believe affect the economy.

Senator CARPER. Yes. Good enough. Mr. Chairman, it has been a good hearing.

Senator COBURN. Thank you all.

Senator CARPER. Thank you.

Senator COBURN. Thank you each for your testimony and your time. We appreciate it.

Mr. Furman and Mr. Entin, I look forward to working with you again in the future. Thank you. Mr. Boortz, thank you.

Mr. BOORTZ. Thank you, sir.

Senator COBURN. The hearing is adjourned.

[Whereupon, at 4:37 p.m., the Subcommittee was adjourned.]

A P P E N D I X

PREPARED STATEMENT OF SENATOR LEVIN

The most recent IRS estimate of the Nation's "tax gap"—the difference between the amount of taxes owed by taxpayers and the amount collected—is a staggering \$346 billion. I commend Chairman Coburn and Ranking Member Carper for their ongoing effort to get to the bottom of the many reasons for this massive tax gap. It is a subject that merits urgent attention from Congress, not only because it short-changes the U.S. Treasury, but because it forces honest American taxpayers to pick up the tab.

Those who abuse the tax system shortchange the men and women who serve in our military, the children who attend our schools, and the millions who rely on Social Security. Tax cheats make it harder to maintain our highways, protect our borders, advance medical research, and inspect our food. They also deepen the deficit ditch that threatens the economic well-being of our children and grandchildren.

Even in Washington, \$350 billion is a huge amount of money. It is larger than the budgets last year of the Departments of Agriculture, Commerce, Education, Interior, Justice, Labor, State, Veterans Affairs, and the Environmental Protection Agency combined. The tax gap is so huge that it would force each individual U.S. taxpayer to pay more than \$2,500 in extra taxes annually to make up for those who are dodging Uncle Sam.

Over the past 4 years, Senator Coleman and I, as Chairman and Ranking Member of the Permanent Subcommittee on Investigations, have conducted extensive investigations that provide insight into two major ways that some Americans are exploiting the system to dodge taxes—offshore tax haven schemes and abusive tax shelters.

Last month, we released a bipartisan report that blows the lid off of offshore tax haven abuses using shell corporations, phony trust, and fake economic transactions to help some people dodge millions of dollars in U.S. taxes. Before that, we released a bipartisan report with case histories showing how accountants, lawyers, bankers, and other tax professionals develop dubious tax shelters and hawk them to Americans across the country. Briefly, here's what we have found.

OFFSHORE TAX HAVEN ABUSES

Experts Joe Guttentag and Reuven Avi-Yonah estimate that offshore tax haven abuses by individuals cost the U.S. Treasury between \$40 billion and \$70 billion every year in taxes that are owed but not collected. On top of that, the IRS has estimated that corporate offshore tax evasion in 2001 totaled about \$30 billion. Put together, that means up to \$100 billion per year in being lost to offshore tax abuses.

Offshore tax haven countries have, in effect, declared economic war on honest U.S. taxpayers by giving tax dodgers a way to avoid their tax bills and leave them for others to pay. Offshore tax havens attract these tax dodgers not only by charging them low or no taxes, but also by shrouding their financial transactions in a "black box" of secrecy that is extremely difficult to penetrate. They sell secrecy to attract customers.

This legal black box allows tax dodgers to hide assets, mask who controls them, and obscure how their assets are used. An army of "offshore service providers"—lawyers, bankers, brokers, and others—then joins forces to exploit the black box secrecy and help clients skirt U.S. tax, securities, and anti-money laundering laws. Many of the firms concocting or facilitating these schemes are respected names here in the United States.

These schemes require the secrecy of tax havens because they can't stand the light of day. Our investigation laid out six case studies that illustrated the scope and seriousness of the problem. In one case, two U.S. citizens moved about \$190 million in untaxed stock option compensation offshore to a complex array of 58 off-

shore trusts and corporations, and utilized a wide range of offshore mechanisms to exercise direction over these assets and hundreds of millions of dollars in investment gains. These untaxed earnings were then used to provide loans, finance business ventures, acquire real estate, and buy art, furnishings and jewelry for the personal use of the family members.

Much of this elaborate scheme involved an offshore bank and administrative services firm for offshore entities, both housed in this building in the Cayman Islands, the Ugland House. Believe it or not, this pretty waterfront building is the official address of 12,748 companies. Just having a post office box here enables these shell companies to shift profits that otherwise should be reported as taxable income in the country where it's actually earned.

In another case study, two offshore shell corporations engaged in fake stock transactions, seeming to trade stock back and forth as if it were fantasy baseball to create the illusion of economic activity. The shell corporations pretended to run up hundreds of millions of dollars in fake stock losses and then used these phantom losses to offset about \$20 billion in real capital gains, the result was \$200 million in lost tax revenue to the Treasury. This offshore scheme, shown in this chart, would be comical because of its complexity but for sobering fact that these tax haven abuses are eating away at the fabric of the U.S. tax system, and undermining U.S. laws intended to safeguard our capital markets and financial systems from financial crime.

Congress could act to shut down these offshore abuses. One step we could take would be to change how the government views transactions in secrecy tax havens. We should shift the burden of proof so that those who move assets offshore or engage in offshore transactions have to prove that income claimed there is not taxable; i.e. that there are real economic transactions, involving real gain or loss, or at least economic activity.

Another simple step would be to require third-party reporting by U.S. financial institutions on a Form 1099 for accounts opened by foreign trusts or corporations where the money is beneficially owned by a U.S. taxpayer.

Congress also needs to dig further into transfer pricing activities. Transfer pricing is an accounting method supposedly requiring that related multinational entities engage in transactions at arm's length to ensure the proper reporting of taxable income. "Supposedly" is the operative word. IRS Commissioner Everson has said that transfer pricing manipulations are one of the most significant challenges that the Service faces, and I don't doubt that one bit. Earlier this month the IRS settled a transfer pricing dispute with drug giant Glaxo Smith Kline for \$3.4 billion. The size of this settlement with just one company indicates that it's worth looking to see if there are ways to improve the relevant portions of the tax code. Treasury has proposed regulations in this area, and I urge the Administration to finalize those rules in as strong a form as possible. I also hope that these and other international tax dodging issues are some of the first we take up in the next Congress.

ABUSIVE TAX SHELTERS

In addition to offshore shenanigans, there are plenty of homegrown tax shelters being used to dodge taxes. In 2003 and 2004, the Permanent Subcommittee on Investigations conducted an in-depth investigation into the widespread involvement of accounting firms, banks, investment advisors, and lawyers in the development, marketing and implementation of abusive tax shelters. We held hearings and reports laying out how these tax shelters are developed and sold to Americans across the country.

Again, Congress can crack down on these abusive tax shelters and offshore schemes if it has the will to do so. One big step would be enactment of S. 1565, the Tax Shelter and Tax Haven Reform Act, which Senator Coleman and I introduced last year. This bipartisan bill would, for the first time, impose real penalties for those who promote abusive tax shelters or knowingly aid and abet taxpayers to understate their tax liability. It would enable the IRS to work with the SEC and bank regulators to clamp down on bankers, securities firms, and lawyers involved with tax haven and tax shelter scams. It would also authorize the Treasury Secretary to issue a list of tax havens that don't cooperate with U.S. tax enforcement and eliminate U.S. tax benefits for income in those jurisdictions. The ability to tax profits that are in fact attributable to U.S. taxpayers but have been camouflaged using these uncooperative tax havens would hand our government a mighty club to combat tax haven abuses.

ADEQUATE IRS ENFORCEMENT

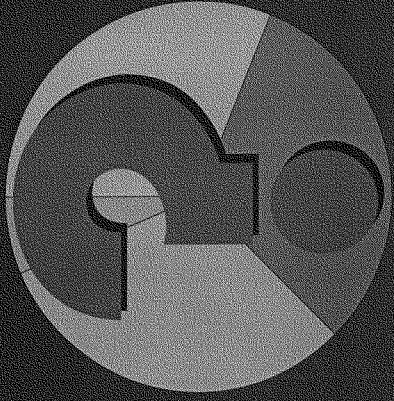
Another key step to reducing the tax gap would be to give the IRS the funds it needs to go after tax dodgers. For every dollar invested in the IRS's budget, the service yields more than \$4 in enforcement revenue. Beyond the additional revenues collected, increased IRS enforcement deters those who might otherwise have dodged their tax obligations and reassures honest taxpayers that compliance with the law is not a chump's game. I hope that Congress will follow the Senate Appropriations Committee's lead and enact the President's full request for the IRS's 2007 budget. I also encourage Treasury and the President to consider asking for more IRS enforcement dollars in the 2008 budget request. I can't think of many better investments to recover revenues wrongfully lost to the U.S. Treasury and to build respect for the law and respect for the honest Americans who play by the rules and meet their tax obligations.

Again, I commend Chairman Coburn and Ranking Member Carper for their efforts on this important topic. I look forward to the testimony today.

Diagnosis Before Treatment



■ intentional
□ unintentional



■ education
■ service
■ enforcement
■ simplification

**WRITTEN TESTIMONY OF THE
COMMISSIONER OF INTERNAL REVENUE
MARK EVERSON
BEFORE
SENATE HOMELAND SECURITY AND GOVERNMENTAL
AFFAIRS COMMITTEE
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENTAL INFORMATION AND INTERNATIONAL
SECURITY
ON
DECONSTRUCTING THE TAX CODE: UNCOLLECTED TAXES
AND THE ISSUE OF TRANSPARENCY**

SEPTEMBER 26, 2006

Good afternoon, Chairman Coburn, ranking member Carper and members of the Subcommittee. It is good to be back before you to update you on the tax gap and our efforts to reduce it. Since I was here almost a year ago, we have updated our tax gap numbers and we have begun a new National Research Program (NRP) study. I will discuss both of those later in my testimony. I would also like to discuss some specific legislative proposals that will assist us in reducing the magnitude of the current tax gap.

Background

Put simply, 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.

It is important to understand, however, that the complexity of our current tax system is a significant reason for the tax gap and that fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions.

History of Estimating the Tax Gap

Historically, 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.

However, this method of data gathering was extremely burdensome on the taxpayers who were forced to participate. One former IRS Commissioner noted that the TCMP audits

were akin to having an autopsy without benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done in 1988.

We conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, all of our subsequent estimates of the tax gap have been rough projections that basically assume no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program, which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 returns for Tax Year (TY) 2001. This was less than previous compliance studies, even though the population of individual tax returns had grown over time.

Like the compliance studies of the past, the NRP was designed to allow us to meet certain objectives: to estimate the overall extent of reporting compliance among individual income tax filers and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The first NRP innovation was to compile a comprehensive set of data to supplement what was reported on the selected returns. The sources of the “case building” data included third-party information returns from payers of income (e.g., Forms W-2 and 1099) and prior-year returns filed by the taxpayers. Also, for the first time, we added data on dependents from various government sources, as well as data from public records (e.g., current and prior addresses, real estate holdings, business registrations, and employment information). Together, all of these data sources reduced the need to ask taxpayers for information, with some of the selected taxpayers not needing to be contacted at all by the IRS. In effect, this additional information allowed us to focus our efforts where the return information could not otherwise be verified. This new approach was so successful it is being expanded into our regular operational audit programs.

A second major NRP innovation was to introduce a “classification” process, whereby the randomly selected returns and associated case-building data were first reviewed by experienced auditors, referred to as classifiers, who identified not only what issues needed to be examined, but also the best way to handle each return in the sample. In this way, each return was either: (1) accepted as filed, without contacting the taxpayer at all (though sometimes with minor adjustments noted for research purposes); (2) selected for correspondence audit of up to three focused issues; or (3) selected for an in-person audit where there were numerous items that needed to be verified. In addition, the classifiers identified compliance issues that the auditors were required to evaluate, though the examiners had the ability to expand the audit to investigate other issues as warranted.

Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders (including representatives of tax professional associations) in the design and implementation of the study.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among the major tax gap components since the most recent compliance data were compiled (i.e., 1988 or earlier).

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 numbers do not reflect taxes owed on income generated from illegal activities. This makes up a significant portion of the underground economy. However, what we think of as the underground economy does not include various forms of tax noncompliance, such as overstated deductions or claiming an improper filing status or the wrong number of exemptions. These are all included in our calculations of the tax gap.

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, even though we do not have the ability to distinguish clearly the amount of non-compliance that arises from willfulness from the amount that arises from unintentional mistakes. We expect future research to improve our understanding in this area. If all reporting errors were unintentional, we would expect to see a relatively even balance between over reporting and under reporting. However, since taxpayer overstatements of tax appear to be much smaller than understatements of tax, one can reasonably infer that much of the gap is the result of intentional behavior.

Latest Numbers

The results of the NRP individual income tax reporting compliance study were rolled into our overall tax gap estimates and show that for the 2001 tax year there was an overall gross tax gap of approximately \$345 billion, corresponding to a noncompliance rate of 16.3 percent. The net tax gap, or what is remaining after enforcement and other late payments, is about \$290 billion.

Noncompliance takes three forms: not filing required returns on time (nonfiling); not reporting one’s full tax liability when the return is filed on time (underreporting); and not paying by the due date the full amount of tax reported on a timely return (underpayment). 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 almost 8 percent and underpayment nearly 10 percent of the gross tax gap.

The individual income tax accounted for about half of all tax receipts in 2001. However, as shown on the chart below, *individual* income tax underreporting was approximately \$197 billion or about 57 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 TY 2001 and, as such, cannot tell us whether compliance trends today are improving or worsening. Moreover, much of the data and estimating methodologies used for the NRP are different than those used in earlier studies.

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) of the underreporting gap 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, non-business deductions, and exemptions) and from overstated tax credits.

NRP-Based Gross Tax Gap Estimates, Tax Year 2001

<i>Tax Gap Component</i>	<i>Gross Tax Gap (\$ billions)</i>	<i>Share of Total Gap</i>
Individual income tax underreporting gap	197	57%
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 Gross 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 constitutes approximately two-thirds of the overall tax gap.

It appears that the sections of the Form 1040 where the most noncompliance occurs have not changed dramatically since the last compliance study was done for Tax Year 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 for wages and salaries is only 1.2 percent.

Amounts subject to third-party information reporting, but not to withholding (such as interest and dividend income), exhibit a somewhat higher misreporting percentage than wages. For example, there is about a 4.5 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 of 8.6 percent. As expected, amounts generally 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 net misreporting percentage for this group of line items is 53.9 percent.

Latest NRP Study

In viewing the strategic value of monitoring compliance trends, we now recognize the need to conduct reporting compliance studies more regularly. Each study will address a component of the overall tax gap. By measuring compliance for various types of taxes and taxpayers, we will be better able to target resources to encourage compliance, deter non-compliance, and reduce the burden on taxpayers.

The most recent NRP reporting compliance study focuses on S corporations. Since 1985, S corporation return filings have increased dramatically. In that year, there were 722,444 Form 1120S returns filed. In 2002, that number had grown by over four times, to over 3.1 million. Compare that to other corporate returns, which declined by approximately 450,000 over the same period.

By 1997, S corporations became 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. The last time we conducted an S corporation compliance study was 1984. As a result, we do not have reliable reporting compliance data for these entities.

The current NRP study of reporting compliance involves approximately 5,000 Form 1120S returns from a nationwide random sample. We used the asset size of the S corporation in the return selection process. This reporting compliance study involves Tax Years 2003 and 2004. This is the first time the IRS has conducted a reporting compliance study across tax years and it will require us to knit the data together to give a comprehensive picture. This study is underway and we expect it to continue through 2007.

Service + Enforcement = Compliance

Reducing the size of the tax gap guides much of what we do on a daily basis at the IRS. Our goal is to increase the voluntary compliance rate from the current 83.6 percent to 85 percent by 2009.

To achieve that goal, we know we must attack the tax gap from both ends of the spectrum. We must help taxpayers better understand their obligations, and reduce that portion of the tax gap attributable to taxpayers being confused or uncertain about what their true obligations are. Secondly, we must improve our enforcement efforts by concentrating on those taxpayers who intentionally refuse to pay what they owe.

Service

The FY 2006 Appropriations Act for the IRS contained report language requesting that we conduct a comprehensive review of our current portfolio of services and develop a five-year plan for taxpayer services. This review was designed to achieve the following objectives:

- Establish a credible taxpayer/partner baseline of needs, preferences, and behaviors;
- Implement a transparent process for making service-related resource and operational decisions;
- Develop a framework for institutionalizing key research, operational, and assessment activities to manage service delivery holistically; and
- Utilize both short-term performance and long-term business outcome goals and metrics to assess service value.

In April 2006, the TAB completed Phase 1 and presented the results of its research to Congress. Phase 1 identified and reported five strategic service improvement themes for enhancing taxpayer and practitioner service needs and preferences:

- Improve and Expand Education and Awareness Activities – Addresses the critical need for making taxpayers and practitioners aware of IRS service offerings and delivery channels and ensuring taxpayers are aware of their tax obligations and benefits;
- Optimize the Use of Partner Services – Emphasizes improving the level of support and direction provided to partners who play a critical role in the delivery of taxpayer services to ensure that they consistently and accurately administer the tax law;
- Elevate Self Service Options to Meet the Expectations of Taxpayers – Continues the process of expanding, simplifying, standardizing, and automating services with a focus on those systems/processes delivering information and basic transactions;
- Improve and Expand Training and Support Tools to Enhance Assisted Services – Ensures the accuracy of information across all channels by improving and

expanding training, technology infrastructure, and support for employees, partners, and taxpayers;

- Develop Short Term Performance and Long Term Outcome Goals and Metrics – Provides for the development of a comprehensive set of short-term performance metrics to evaluate how well the business is meeting taxpayer expectations (education and awareness, access to service, and quality of experience) and how efficiently it is delivering those services (compliance, IRS and taxpayer costs, and productivity);

TAB Phase 2 is in progress and is already yielding significant results. Phase 2 is currently focused on developing refined taxpayer/partner needs and preference data, identifying current planning documents, decision processes, and existing commitments affecting IRS service strategy. It is developing a decision model to prioritize service initiatives and funding proposals, recommending service improvement initiatives, creating short-term performance and long-term outcome metrics, ensuring continued stakeholder, partner and employee engagement, and delivering a multi-year research plan.

Over 27 distinct research initiatives have produced extensive data on how taxpayers perceive, use, and value services. We are in the process of analyzing this significant body of work. Similarly, TAB is integrating cross functional strategic activities reflected in initiatives such as the Modernization Visioning Strategy and Electronic Tax Administration's (ETA) Strategy for Growth. As a consequence of this scope of activity, the Phase 2 report delivery has been delayed until January 2007.

Based on the results of these efforts, improvement initiatives will be recommended by TAB intended to increase voluntary compliance, taxpayer and partner value, and IRS business value.

While TAB remains a work in progress, consideration is also being given to other program initiatives that will address inadvertent, unintentional errors caused by:

- Language barriers - by pursuing strategies that focus on providing tax information in languages other than English;
- Educational barriers - by pursuing strategies that focus on expanding and improving the quality of voluntary assistance through Voluntary Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) centers and similar partnership efforts. In the 2006 filing season, over 12,000 VITA and TCE sites were opened with more than 68,000 volunteers. These sites filed approximately 2.26 million tax returns, of which 82.7% were e-filed;
- Misunderstanding of tax law - by pursuing strategies that focus on clarifying and improving forms, instructions, and publications to reduce the burden that taxpayers experience in attempting to comply;
- Communication barriers - by pursuing strategies that focus on improving the quality, ease of use, and access to printed, electronic, and telephonic assistance

channels; placement of face-to-face assistance resources to cost effectively serve taxpayers unlikely to use other service channels;

- Practitioners' lack of knowledge/understanding of tax law - by pursuing strategies designed to enhance the quality and accessibility of practitioner assistance through education, tailored assistance channels, and effective monitoring of practitioner behavior and return preparation quality.

On April 30, 2006 we established the Tax Forms and Publication's Virtual Translation Office (VTO). This office will allow IRS to increase service to Limited English Proficient taxpayers and expand the amount of tax materials in languages other than English. Initially, VTO will focus on expanding Spanish language materials, including the development of tax information for small business. Expansion of tax information for 4 targeted languages (Mandarin/Cantonese, Korean, Vietnamese and Russian) is anticipated in Fiscal Years beyond 2007.

Another major service initiative is the continued enhancement of IRS.gov with the goal that this site will become the first choice of individual taxpayers and their preparers when they need to contact IRS for help. In 2006, there have been more than 163 million visits to the site, up 8.6 percent from 2005.

Services now provided on IRS.gov include:

- An Alternative Minimum Tax (AMT) Assistor to help taxpayers in determining whether they may be subject to the AMT and whether they need to complete Form 6251;
- EITC Assistant that allows individuals to determine whether they qualify for the Earned Income Tax Credit and is available in both English and Spanish;
- The IRS Withholding Calculator which allows employees to determine how much should be withheld from their paycheck;
- The Small Business/Self Employed division provides online learning and educational products which allows business owners to view a streaming video of an IRS Small Business Workshop, take an IRS course, or complete an online, self-directed version of a workshop taught live around the country;
- Online ordering capability for numerous tax forms and products, which give customers access to free products that help them meet their tax requirements. They can choose from a variety of products, as well as get updated information relating to any of those products;

"Where's My Refund" is another important feature of IRS.gov. It allows taxpayers to track their refund. Over 22 million taxpayers used this feature in our most recent filing season, a 2.7 million increase from 2005. The increased use of "Where's My Refund?" has reduced the number of phone calls from taxpayers seeking their refund status.

Another key component of our overall strategy to increase taxpayer use of electronic options is electronic filing. The present e-filing system has demonstrated measurable success with regard to individual taxpayer satisfaction. From its modest beginning as a

pilot program in 1986, when 25,000 returns were filed electronically, the number of e-filed returns has dramatically increased, with more than 71 million returns filed electronically in the last filing season. The benefits to these taxpayers include:

- *Faster refunds:* Direct deposit can speed refunds to e-filers in about two weeks or less. Through early September, 2006, 56.3 million refunds were direct deposited, up from the 52.4 million refunds for the same period in 2005. The average direct deposit refund in 2006 is \$2,601.
- *More accurate returns:* E-filed returns are automatically checked for errors or missing information. Processing is more accurate and the likelihood that a taxpayer might receive an error letter from the IRS is reduced.
- *Quick electronic confirmation:* E-filers receive an electronic acknowledgement that their return has been received.
- *Free Internet Filing:* Now in its fourth year, Free File allows millions of taxpayers to prepare and file their federal tax returns on-line for free. The program is a partnership between the IRS and an alliance of tax software companies that offers free on-line tax return preparation and e-filing services to 70 percent of the nation's taxpayers. Free File volume for the 2006 filing season was almost 4 million returns.
- *Easy payment options:* E-filers with a balance due can file early and schedule a safe and convenient electronic funds withdrawal from their bank account, or pay with a credit card.
- *Federal/State e-filing:* Taxpayers in 37 states and the District of Columbia can e-file their Federal and state tax returns in one transmission to the IRS. The IRS forwards the state data to the appropriate state agency.

We are also continuing our efforts to reduce taxpayer burden through the efforts of our Office of Taxpayer Burden Reduction (OTBR). Recent improvements in IRS forms, processes, and procedures coordinated through TBR include:

- *Simplified Tax Filing Requirements for Form 944:* Beginning January 1, 2006, certain employment tax filers are able to file the new Form 944 (Employer's Annual Federal Tax Return) once a year rather than filing Form 941 (Employer's Quarterly Federal Tax Return) four times a year. The first Form 944 is due January 31, 2007. Form 944 will also be available in Spanish (944SP and 944PR);
- *Revised Schedule K-1 for Partnerships, S-corporations and Trusts:* Form 1041 Schedule K-1 was revised for filing season 2006. The Schedule K-1 has been simplified to reduce common errors and the burden associated with the preparation and filing requirements. Schedule K-1 for Forms 1065 and 1120S was revised last year;
- *Extension of Time to File:* We eliminated the need for filing Form 2688, Application for Additional Extension of Time to File U.S. Individual Income Tax Return, by allowing the taxpayer to get a 6 month extension to file initially. This change eliminates over 3.7 million forms and 2.2 million hours of taxpayer burden;

- *Disaster-related Burden Reduction:* As a result of recent disaster legislation, victims of hurricanes Katrina, Rita, and Wilma who experienced smaller earned incomes in 2005, can elect to compute their EITC and Additional Child Tax Credit using their larger 2004 earned income. A new IRS.gov feature – *Your 2004 Earned Income Option* – gives hurricane victims who lost their tax records immediate, 24/7, access to their 2004 earned income, allowing them to take advantage of this special election without filing delays. Taxpayers can access their 2004 earned income amount by entering two shared secrets to protect their confidential data. Hurricane victims without Web access can retrieve the same information through an automated phone application via a disaster hotline. Additionally, the EITC Assistant on IRS.gov helps hurricane victims estimate which year's earned income results in a larger EITC credit.

IRS.gov, electronic filing, and the efforts of OTBR are just three examples of a number of initiatives we have underway to utilize the latest technology to assist taxpayers in meeting their obligations. An underappreciated benefit of all of our e-service initiatives is that every electronic interaction we have with a taxpayer is one less human interaction. That means that those human resources can be devoted to other, more labor intensive activities that will help reduce the tax gap.

Enforcement

While we know that confusion and a lack of understanding are two contributors to the tax gap, we also know that some taxpayers consciously avoid paying what they owe. It is one thing for a small business to unknowingly apply incorrect depreciation rules to an asset, but it is something different for the same small business to fail to report income that it earned.

We have four enforcement priorities, which are to:

- Discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individual taxpayers, and other contributors to the tax gap;
- Assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law;
- Detect and deter domestic and offshore-based tax and financial criminal activity; and,
- Discourage and deter non-compliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance. Detecting and investigating money laundering activity is an important part of tax

We are making progress on all four priorities but we are especially pleased with the first two as we are seeing evidence of changed behavior in the marketplace on the part of tax professionals, including accountants and lawyers. No longer are abusive tax shelters being marketed by top level accounting firms.

A prime focus of our enforcement efforts in recent years has been high income individuals, those with incomes in excess of \$100,000, and corporations. In FY 2000, we audited 99,457 high income individuals. By FY 2005, that number had risen to almost 220,000. Similar increases can also be seen in the coverage rates. The rate in FY 2000 for high income individuals was 0.96 percent, as opposed to 1.57 percent in FY 2005. The coverage rate for those with incomes over \$1 million is 5 percent. Our plan in FY 2006 is to complete 234,000 high income individual audits. We are well ahead of that schedule currently and may reach as many as 240,000 or more.

Over the last several years, the Service has also, by design, increased the coverage rate of corporations that we audit. In Fiscal Year (FY) 2005, we audited 10,800 corporations with assets over \$10 million compared to approximately 9,500 in 2004. There was a coverage rate of 20 percent in FY 2005, a coverage rate of 16.7 percent in FY 2004, and a coverage rate of 12.1 percent in FY 2003. Based on year to date data we anticipate we will maintain the same level of audits in FY 2006 and the same coverage rate as in FY 2005.

For corporations with assets under \$10 million, the coverage rate has increased as well. In FY 2005, we examined 17,858 small corporations, a coverage rate of 0.79 percent. This is more than double the audit rate in FY 2004 (0.32 percent). We expect our FY 2006 numbers to be similar to the 2005 numbers.

Overall, the enforcement dollars we collect has continued to rise. In FY 2001 we collected \$33.8 billion. In FY 2005, that had risen to \$47.3 billion. We expect when FY 2006 closes in a few days the enforcement revenue will rise again to approximately \$49.1 billion.

While we are doing more, we are not yet where we want to be or need to be. Compliance by large businesses and high-wealth individuals remain two of the Service's strategic priorities.

In general, we are attempting to take a proactive approach to dealing with the challenges of effective tax administration. Overall, our strategy depends on making compliance checks as much as possible on a real-time or near-real-time basis, being as current in our examinations as possible, and having as much transparency to book-tax differences and other indicators of risk as possible. To that end, we have initiated several programs that foster transparency, currency, pre-filing compliance opportunities, and improved efficiencies in issue and risk identification.

We have found that on particularly complex compliance issues cross-functional Issue Management Teams (IMTs) can be successful when we employ them to provide executive oversight and focus upon areas of high risk. We have used IMTs to combat tax shelters, and have expanded their use to include other areas of high compliance risk. We have also used special teams of experienced personnel to assist with the examination of specific issues in the tax shelter arena and plan to use similar teams to address other

compliance issues. Additionally, we are working to enhance the use of internal web site information to better inform examiners of high risk areas and the steps they must take to ensure consistent application of the law. Let me mention some of our key efforts. First, to improve transparency on corporate tax returns, we introduced a new Schedule M-3. The Schedule M-3 provides transaction-specific detail on book-tax differences, enabling us to identify and focus more quickly and precisely on those tax returns and issues that present the highest potential compliance risk.

Second, we introduced the Compliance Assurance Program (CAP), to improve both currency and transparency. CAP is a real-time approach to compliance review that allows us, working in conjunction with the taxpayer, to determine tax return accuracy prior to filing. We believe CAP is more efficient than a post-filing examination—we are currently piloting the model and will refine it as necessary—as it provides corporations certainty about their tax liability for a given year within months, rather than years, of filing a tax return. This win-win program greatly reduces taxpayers' compliance burden and the need for reserving contingent tax liabilities on their financial statements, while increasing currency and allowing for more efficient use of our resources.

Third, we are conducting the Pre-Filing Agreement (PFA) program to provide taxpayers an opportunity to request that revenue agents examine and resolve potential issues before tax returns are filed. We continue to explore ways to improve and create additional pre-filing compliance opportunities.

Fourth, we are also attempting to identify emerging high risk issues as early as possible, issuing guidance to taxpayers and examiners on the proper treatment of these issues, and efficiently and vigorously examining those returns where taxpayers engage in that behavior.

Fifth, we are mandating, in stages, the electronic filing of large corporate returns (*E-filing*) in order to improve issue identification and the selection for examination of high risk returns. Large corporations are required now to file their tax returns electronically and this mandate will expand in future tax years. *E-filing* will provide more consistent treatment and data analysis for efficient, near real time identification of high risk issues and taxpayers. *E-filing* and Schedule M-3 together also allow us to more efficiently identify and exclude lower risk taxpayers from consideration for examination.

Two of the key challenges facing revenue bodies around the world in the 21st century are international non-compliance and organizational reforms for more effective tax administration. I just returned 10 days ago from chairing the meeting of the Organization for Economic Co-operation and Development's (OECD) Forum on Tax Administration held in Seoul, South Korea. The leaders of tax administrations in 30 countries were in attendance.

One of the things we concluded was that enforcement of our respective tax laws has become more difficult as trade and advances in communication technologies have opened the global marketplace to a wider spectrum of taxpayers. While this more open economic

environment is good for business and global growth, it can lead to structures which challenge tax rules, and schemes and arrangements by both domestic and foreign taxpayers to facilitate non-compliance with our national tax laws. We agreed to improve practical co-operation between revenue bodies and other law enforcement agencies of governments to counter non-compliance.

Our discussions also revealed continued concerns about corporate governance and the role of tax advisors and financial and other institutions in relation to non-compliance and the promotion of unacceptable tax minimization arrangements. We also noted the increased flows of capital into private equity funds and the potential issues this may raise for revenue bodies.

We identified four areas in which we will intensify existing work or initiate new work under the auspices of the OECD:

- Further developing the directory of aggressive tax planning schemes so as to identify trends and measures to counter such schemes.
- Examining the role tax intermediaries (e.g., law and accounting firms, other tax advisors and financial institutions) in relation to non-compliance and the promotion of unacceptable tax minimization arrangements with a view to completing a study by the end of 2007.
- Expanding the OECD 2004 Corporate Governance Guidelines to give greater attention to the linkage between tax and good governance.
- Improving the training of tax officials on international tax issues, including the succession of officials from one administration to another.

Legislative Initiatives

While fundamental tax reform is the only comprehensive solution to reducing the tax gap, until that is achieved, we must work within the current system to reduce the tax gap as much as possible. Allow me to discuss five specific legislative proposals that were offered as part of the FY 2007 budget and designed to reduce the tax gap. Collectively, these five changes should generate \$3.6 billion over the next ten years.

The first, and perhaps most important, proposal would increase reporting on payment card transactions. Our tax gap study shows clearly that increased information reporting and backup withholding are highly effective means of improving compliance with tax laws. More than 150 million wage earners already have their information reported directly by their employer to the IRS and the noncompliance rate for this group is approximately 1 percent. All of these wage earners are also subject to mandatory withholding of taxes.

Payment cards (including credit cards and debit cards) are being used increasingly in retail business transactions. The failure of some merchants to report accurately their gross income, including income derived from payment card transactions, accounts for a

significant portion of the tax gap and creates an unfair competitive advantage for those businesses that underreport.

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. Withholding would only be required as a backup in the event that a merchant payee fails to provide a valid taxpayer identification number.

Because reimbursement information is already provided to merchants, requiring this information to be reported to the IRS on an aggregate annual basis will impose minimal burden on payment card companies and no burden on the affected merchants. Finally, the IRS will be able to use payment card reporting information to better focus its resources and relieve the burden that existing audits place on businesses that accurately report their gross income.

The second legislative proposal would clarify when employee leasing companies can be held liable for their clients' Federal employment taxes. 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.

Noncompliance with the Federal employment tax reporting and withholding requirements is a significant part of the tax gap. Under present law, it may be unclear 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 should be 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 allow employee leasing companies to qualify to be solely liable if they met certain specified standards.

Our third proposal would amend collection due process procedures for employment tax liabilities. Currently, we are authorized to take various collection actions including issuing Federal tax levies to collect past-due taxes. Before a Federal tax levy can be issued, however, the IRS generally must provide the taxpayer with notice and an opportunity for an administrative collection due process (CDP) hearing and judicial review.

Frequently, an employer who fails to satisfy its Federal employment 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 a hearing and judicial review for each period. The existing CDP framework compounds the pyramiding problem by depriving the government of enforced collection as a tool to encourage employers to satisfy their current Federal employment tax obligations.

Our proposal would allow the levy to be imposed prior to a CDP hearing in a fashion similar to current law provisions for 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. Taxpayers would also continue to have access to existing pre-collection administrative appeal rights other than CDP.

The fourth proposal would require increased information reporting and backup withholding for certain government payments for property and services. While the dollar amount of the tax gap attributable to non-compliant government vendors may be relatively small, recent Congressional hearings have highlighted the significant indirect impact on compliance of government payments being made to taxpayers who fail to meet their own tax obligations. A modified version of this proposal was enacted in the Tax Increase Prevention and Reconciliation Act of 2006. Under that Act, those payments will be subject to withholding at a 3 percent rate, beginning in 2010.

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

These legislative proposals strategically target areas where (1) research reveals the existence of significant compliance problems, (2) improvements will burden taxpayers as little as possible, and (3) the changes support the Administration’s broader focus on identifying legislative and administrative changes to reduce the tax gap.

FY 2007 Budget

A critical element in our ability to make a serious dent in the tax gap is to have the necessary resources available to fund our service, enforcement, and information technology programs. We are grateful that Congress saw fit to fully fund the IRS in FY 2006. This allowed us to focus additional resources on the following key initiatives:

- Increased coverage of high-risk compliance problems to address the largest portion of the tax gap --- the underreporting of tax--- across all major compliance programs;
- Complex, high-risk issues in abusive tax avoidance transactions, promoter activities, corporate fraud, and aggressive transactions, resulting in increased corporate and high income audit coverage;
- Efforts aimed at reversing the erosion of individual tax compliance and support of the strategy to implement a balanced compliance program;
- Improved ability to identify compliance risks and significantly expanded coverage of tax-exempt organizations;
- Safeguarding compliant customers from unscrupulous promoters through earlier detection of abusive schemes and heightened efforts to prevent their proliferation; and
- Increased vigilance to ensure the assets of tax-exempt organizations are put to their intended tax-preferred purpose and not misdirected to fund terrorism or for private gain, including enhanced processing of questionable exemption applications and increased technical support to the examination process.

Our total budget request for FY 2007 is \$10.6 billion in direct appropriations, supplemented by \$135 million in new user fee revenue, for a total operating level of \$10.7 billion. This request represents a total increase of 1.4 percent from the FY 2006 enacted level. The FY 2007 Budget sustains the enforcement funding increase provided in FY 2006 to improve tax compliance. More importantly, the budget maintains the balance between service and enforcement.

Unfortunately, the House Appropriations bill reduces the President's request for IRS by nearly \$105 million. If this were to be enacted, it would represent a serious setback for our overall efforts to reduce the tax gap.

The bill approved by the Senate Appropriations committee is much more reflective of the President's request and the resource needs of the IRS in the coming fiscal year.

Conclusions

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 as much as possible of the other 16 percent. Otherwise, honest 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 also know that transparency and third party reporting are critical components to ensuring compliance

We will continue our efforts to maintain the balance between service and enforcement. 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 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.

STATEMENT OF

THE HONORABLE J. RUSSELL GEORGE
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION
before the
U.S. SENATE COMMITTEE ON HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENT INFORMATION AND INTERNATIONAL SECURITY

“Deconstructing the Tax Code: Uncollected Taxes and
Issues of Transparency”

September 26, 2006

Introduction

Chairman Coburn, Ranking Member Carper, and Members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss the tax gap and Internal Revenue Service (IRS) efforts to close it. My statement today is drawn from previous Treasury Inspector General for Tax Administration (TIGTA) reports and testimonies covering the tax gap and IRS compliance efforts, which were done in accordance with government auditing standards, as well as reviews of relevant studies and literature.

The objective of our tax system is to fund the cost of government operations. The IRS attempts to meet this objective by implementing a tax system that provides adequate funding for the Federal Government and is fairly applied to all taxpayers. But, as we know, the system has failed to capture a significant amount of the tax revenue that is owed, which we call the tax gap. The IRS defines the tax gap as “the difference between what taxpayers are supposed to pay and what is actually paid.”¹

It is worth noting, that if we were to capture the estimated annual tax gap, it would offset the projected fiscal year (FY) 2006 budget deficit of \$260 billion and give us a surplus of approximately \$95 billion. Because the tax gap poses a significant threat to the integrity of our voluntary tax system, one of my top priorities for TIGTA is to identify opportunities for improvements to the IRS’ tax compliance initiatives.

Similar to nearly all other Federal agencies, the IRS has limited resources to apply to the objectives it seeks to achieve. Nevertheless, the IRS must face the challenge of increasing voluntary compliance and reducing the tax gap. When I testified on the tax gap in July I reported that some of the most challenging barriers to closing the tax gap are tax law complexity, incomplete information on the tax gap and its components, and

¹ *Hearings on Bridging the Tax Gap Before the Senate Committee on Finance*, 108th Cong. (2004) (statement of Mark Everson, Commissioner of Internal Revenue).

reduced IRS enforcement resources. To an extent, a portion of the tax gap can be closed through more effective enforcement and a commitment of additional enforcement resources. A significant portion of the gap, however, may not be amenable to traditional examinations and audits. Other means might better address that portion, such as tax law simplification and increased third-party reporting. Some of TIGTA's more significant findings and recommendations to improve tax administration and help the IRS reduce the tax gap are presented later in my testimony.

The Tax Gap: Its Size and Sources

The IRS describes the tax gap as having three primary components — unfiled tax returns, taxes associated with underreported income on filed returns, and underpaid taxes on filed returns.² Within the underreported income component, the IRS has further delineated specific categories of taxes, such as individual, corporate, employment, estate, and excise taxes.³

In 2006, the IRS updated its estimate of the tax gap, which had been based on data for tax year (TY) 1988. The new estimate was based on data obtained from the National Research Program (NRP) for TY 2001 individual income tax returns.⁴ Data from the NRP were used to update the 2001 tax gap figures. The IRS developed a chart called the tax gap map to graphically depict the gross tax gap for TY 2001, its components, and their relative sizes.

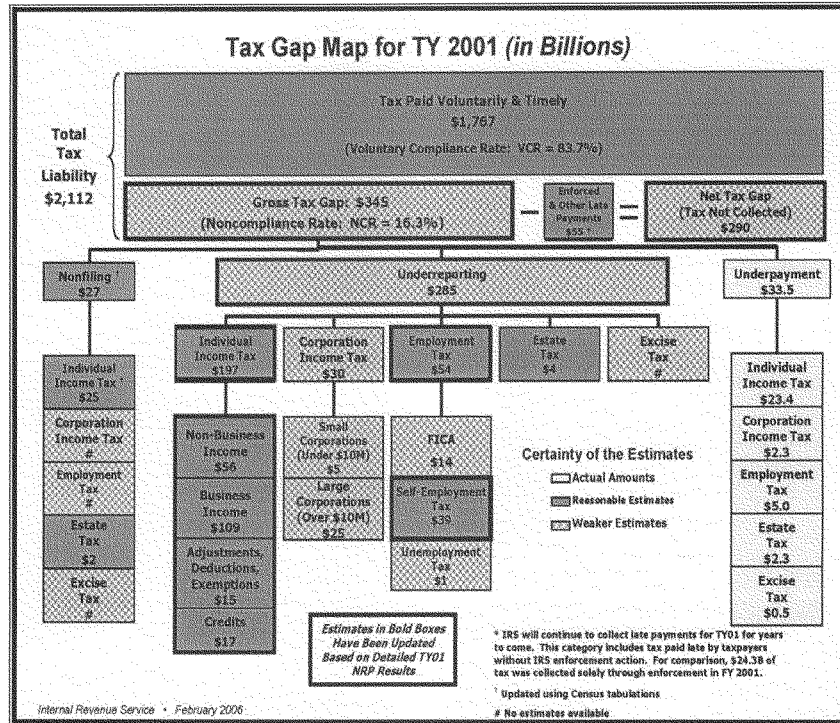
The map attributes various certainties to the tax gap estimates, representing the IRS' confidence in the figures based on the quality and age of the estimates. Figure 1 shows the most recent version of the tax gap map.

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

³ This category includes the lesser amounts of overclaimed credits and deductions.

⁴ Prior to the National Research Program, tax gap estimates were based on the results of the IRS Taxpayer Compliance Measurement Program (TCMP), which was a systematic program of tax return examinations conducted to facilitate the compilation of reliable compliance data. The last TCMP process involved TY 1988 individual income tax returns.

Figure 1: IRS Tax Gap Map



Source: IRS

As shown in the preceding tax gap map, the IRS' TY 2001 gross tax gap estimate for individual, employment, corporate, and other taxes is \$345 billion with a voluntary compliance rate (VCR) of 83.7 percent based on the NRP data.

A logical starting point for any discussion about whether a specific VCR goal can be met is an assessment of the reliability of the measurement data. In April 2004, Senator Baucus called for a 90 percent VCR by the end of the decade. Based upon the best information the IRS had available as of February 2006, the gross tax gap for TY 2001 was approximately \$345 billion and the VCR was approximately 83.7 percent. Assuming the current IRS tax gap and VCR were complete and accurate, the 90 percent compliance target would present major challenges to tax administration. For example, assuming that in TY 2010 the total tax liability is the same as it was in TY 2001, to reach a level of 90 percent voluntary compliance, noncompliant taxpayers would have to timely and

voluntarily pay an additional \$134 billion.⁵ The IRS has proposed a less aggressive VCR goal of 85 percent by 2009.

Regardless of the VCR goal, TIGTA has concerns in all three compliance areas across the major tax gap segments about whether the tax gap projections are complete and accurate.⁶ TIGTA's primary concerns involve the areas of nonfiling, underreporting, and estimated payments that result in the difference between the gross and net tax gaps.⁷

Nonfiling

Prior to the NRP, the IRS estimated the nonfiling gap to be \$30.1 billion, which was composed of \$28.1 billion in individual income taxes and \$2 billion in estate taxes. In February 2006, the IRS updated this estimate to \$25 billion in individual income taxes. The individual estimate was based on data provided by the U.S. Census Bureau. However, there are supplemental data that suggest substantial amounts are not included in the tax gap estimates. For example, the IRS tax gap map describe the nonfiling estimate as reasonable despite the missing segments of corporate income, employment, and excise taxes. The IRS does not have definite plans to update the estate tax segment⁸ or to estimate the corporate, employment, and excise tax nonfiler segments, suggesting that the nonfiler estimate is incomplete and likely inaccurate.

In July 2004, researchers in the Small Business/Self-Employed (SB/SE) Division issued a report on business nonfilers recommending implementation of an enhanced system for creating and selecting inventory. Subsequently, the SB/SE Division research office developed a prototype that matched \$4.6 trillion in transactions to over one-half of the business nonfilers for TY 2002, detecting approximately \$1 trillion of apparent taxable income. That fact alone brings the \$27 billion individual and estate nonfiling estimate into question and demonstrates the need for more research to better estimate nonfiling for all tax segments.

Underreporting

The tax gap attributed to underreporting is by far the largest identified portion of the tax gap at an estimated \$285 billion. Yet, TIGTA concluded that this estimate may not be complete since there are at least four areas that suggest substantial amounts are not included in the tax gap map projections.

- *First*, the business income portion of the individual underreporting tax gap estimate is incomplete because it lacks information from another NRP study that the IRS is

⁵ The IRS' goal in its 2007 budget is to reach an 85 percent VCR by 2009.

⁶ *Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections* (Reference Number 2006-50-077, dated April 2006).

⁷ The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. The portion of the gross tax gap that is not eventually collected is called the net tax gap.

⁸ Currently consideration is being given to eliminating or reducing the number of people required to pay estate taxes.

undertaking on flowthrough returns⁹ of Subchapter S corporations.¹⁰ The study, which began in October 2005, will take two to three years to complete. Thus, the information from these audits was not available for the February 2006 updated TY 2001 tax gap estimates. Over 2.9 million Subchapter S Corporation returns were filed in TY 2001 with more than 5.3 million shareholders reporting \$187.7 billion in net income.

- *Second*, the tax gap map lists the underreporting gap at \$5 billion for small corporations and \$25 billion for large corporations. These amounts are essentially carryovers from the previous estimate and are of weaker certainty since no new information was developed. For small corporations, the estimate is based on the 1980 Taxpayer Compliance Measurement Program (TCMP) survey. For large corporate underreporting, the previous estimates were not based on random TCMP audits but on operational audit coverage from the mid-1980s. These projections assume constant VCRs, yet current experience suggests compliance may not be constant. For example, in 2003, an IRS contractor estimated that the yearly tax gap arising from abusive corporate tax shelters alone was between \$11.6 billion and \$15.1 billion.¹¹
- *Third*, the map similarly categorizes as reasonable a \$4 billion figure for estate taxes and provides no estimate for excise taxes, yet the estate tax estimate was not updated during the current NRP. In addition, there are no firm plans for further studies or updates of these components.
- *Fourth*, for the employment tax component, the combined \$15 billion Federal Insurance Contributions Act and unemployment tax gap figure was also carried over and will not be further studied. Most of the employment tax component consists of self-employment tax. Yet, similar to the business income portion of the individual income tax gap, this, too, is incomplete without the flowthrough data.

Payments collected

The IRS' tax gap maps, both before and after the NRP, list \$55 billion as recoveries or enforced collections and other late payments.¹² This figure does not represent an actual amount but is an estimate projected from historical information and formulas based on what is known about the amount of collections on accounts over time. However, TIGTA

⁹ These include partnerships and Subchapter S corporations through which individual partners and shareholders, respectively, derive tax information from those entities. The flowthrough study covers only Subchapter S corporations and not partnerships. In 1958, Congress established Subchapter S of the Internal Revenue Code that enables small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders. Subsequently, the Code was revised to allow as many as 100 shareholders. Electing this form of business organization, commonly referred to as an S corporation, exempts the profits from corporate taxation and allows the profits to "pass through" to the shareholders who are then responsible for individual income taxes on the profits.

¹⁰ The study began in October 2005 with audits of TY 2003 returns.

¹¹ The IRS has not developed a new estimate of this figure.

¹² According to one IRS representative, these collections can take up to 10 years because of appeals and court decisions.

found the actual basis of these formulas to be very limited, as well as dated. IRS officials acknowledge that these formulas were developed “quite some time ago.” Thus, these formulas most likely do not take into account changes in the IRS’ ability to collect revenue.

To determine the validity of the potential \$55 billion in collections, TIGTA requested data from the IRS on actual collections for TY 2001 by year of collection. These collections have two basic components: voluntary payments received by the IRS after the due date and payments received by the IRS as a result of some type of IRS intervention. The IRS, however, does not currently correlate either type of payment to the applicable tax year. Consequently, the IRS has no means of determining whether the \$55 billion is ever collected. While the IRS is currently developing a way to associate collections resulting from enforcement actions to the related tax years, no similar data are being developed for voluntary late payments. Unless the latter data are similarly correlated, the IRS will be unable to determine actual collections or an accurate net tax gap.

In summary, much of the information remains dated, the new information is incomplete in several respects, and methodology differences create challenges. Considering this, a somewhat different picture of the tax gap map emerges. TIGTA has concluded that despite the significant efforts undertaken in conducting the individual taxpayer NRP, the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and the VCR. Although having new information about TY 2001 individual taxpayers is a considerable improvement over the much older information based on the last TCMP survey in TY 1988, some important individual compliance information remains unknown. Additionally, although individuals comprise the largest segment of taxpayers and were justifiably studied first, no new information is available about employment, small corporate, large corporate, and other compliance segments is available. With no firm plans for further studies or updates in many areas of the tax gap, both the underreporting tax gap and the nonfiling gap will indefinitely leave an unfinished picture of the overall tax gap and compliance.

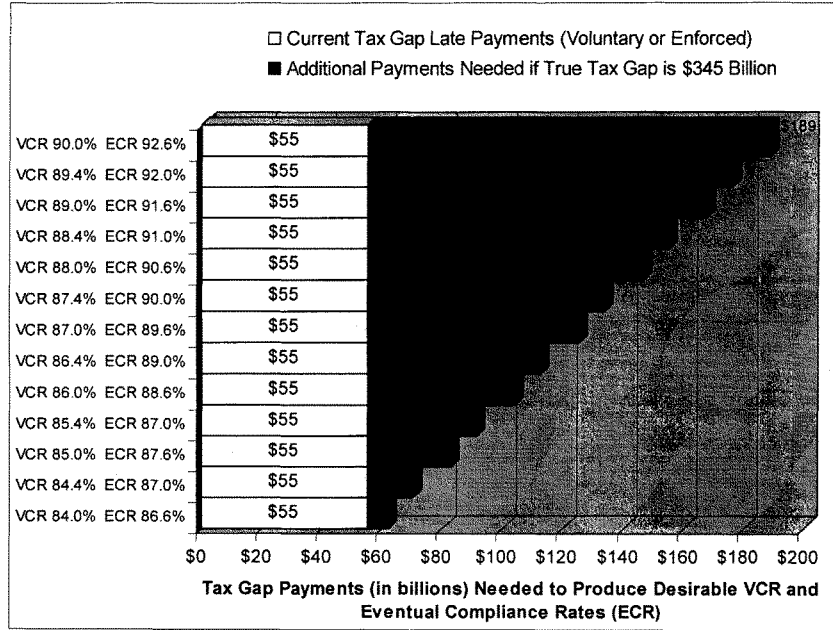
Achieving Targeted Voluntary Compliance Goals

While TIGTA has concerns about the overall reliability of the tax gap projections, the annual amounts collected that reduce the net tax gap, and the VCR, TIGTA determined that it was instructive to analyze what additional amounts the IRS would have had to collect to reach 90 percent voluntary compliance at different estimated intervals for TY 2001. Figure 3 shows the range for TY 2001 based upon the total tax liability for TY 2001 as estimated in February 2006. The IRS has proposed in the FY 2007 budget that the VCR will be raised from 83.7 percent to 85 percent by 2009. Accordingly, if the total tax liability remained constant, the IRS would have to collect, on a voluntary and timely basis, \$28 billion more in TY 2009, thus reducing the gross tax gap to \$317 billion. To reach 90 percent voluntary compliance by TY 2010,¹³ the amount voluntarily and timely

¹³ This is the amount previously described in this report that was called for by Senator Baucus. See *Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal*

collected for TY 2010 would be an additional \$134 billion, thus reducing the gross tax gap to \$211 billion if the total tax liability remained constant.

Figure 3: Additional Voluntary and Timely Payments Required to Reach Specified VCR Levels¹⁴



Source: Treasury Inspector General for Tax Administration

Barriers Hampering Compliance Research

Performing a compliance measurement program is expensive and time consuming. The estimated cost for performing the TY 2001 individual taxpayer NRP was approximately \$150 million. According to IRS officials, resource constraints are a major factor in NRP studies and affect how often the NRP is updated. Operational priorities must be balanced against research needs. From FY 1995 through FY 2004, the revenue agent workforce declined by nearly 30 percent while the number of returns filed grew by over 9 percent.

Revenue Service Tax Gap Projections, (TIGTA Reference Number 2006-50-077, dated April 2006.

¹⁴ Payment of the \$55 billion estimated by the IRS as late or enforced payments does not affect the VCR. However, it does affect the total amount collected by the IRS. Therefore, we developed the Eventual Compliance Rate term that shows the effect of these payments when coupled with additional voluntary and timely payments that do affect the VCR.

This shortfall in examiner resources makes conducting large-scale research studies problematic.

The IRS' budget submission to the Department of the Treasury (the Department) for FY 2007 requests funding to support ongoing NRP reporting compliance studies. The IRS Oversight Board supports ongoing dedicated funding for compliance research. Unfortunately, funding for those resources in previous fiscal years did not materialize. Without a resource commitment for continual updating of the studies, the information will continue to be stale and less useful in measuring voluntary compliance.

Learning From Previous Attempts to Reduce the Tax Gap

In June 1993, IRS executives met with the Department and Office of Management and Budget (OMB) officials to discuss key issues for the FY 1995 budget. The issues facing the Federal Government at that time were similar to the current issues: severe fiscal constraints and the desire for good tax administration. Consequently, both the Department and OMB agreed to work with the IRS on a comprehensive plan to reduce the tax gap.¹⁵ The IRS formed a task group that performed an extensive review of the tax gap.¹⁶ The resulting task force report addressed the major areas of the tax gap and provided recommendations. The report concluded that:

- Enforcement is the most costly option and delivers only limited revenue;
- Methods to increase voluntary compliance are less costly but more burdensome to taxpayers;
- Legislative changes are needed as the primary means to increase compliance levels;
- The TCMP surveys can be used to identify the types of noncompliance but not the causes;
- The IRS needs to reevaluate its media and taxpayer education efforts;
- The tax gap needs to be treated as a multibillion dollar market, and efforts need to be made to capture as much of that market as possible;
- The IRS needs to consider making a high-level official responsible for overseeing efforts to close all components of the tax gap; and
- The IRS Strategic Plan needs to be modified to more closely align with the tax gap components.

¹⁵ IRS Tax Gap Report: Strategies for Closing the Tax Gap, October 1993, page 3.

¹⁶ IRS Tax Gap Report: Strategies for Closing the Tax Gap, October 1993.

Opportunities for Closing the Tax Gap

Although better data will help the IRS identify noncompliant segments of the population, broader strategies and better research are also needed to determine what actions are most effective in addressing noncompliance. The IRS must continue to seek accurate measures of the various components of the tax gap and the effectiveness of actions taken to reduce it. This information is critical to the IRS for strategic direction, budgeting and staff allocation. The Department also needs these measures for tax policy purposes. Additionally, Congress needs this information to develop legislation that improves the effectiveness of the tax system.

Recommendations on how to close the tax gap have been circulating for many years. Some of those recommendations, made over 15 years ago, are still relevant today. I would like to focus on the following opportunities that TIGTA, other oversight groups, and interested stakeholders have identified to address the tax gap:

- Reduce the Complexity of the Tax Code;
- Gather Better Compliance Data;
- Refine Compliance Strategies;
 - High-Income Taxpayers;
 - Abusive Tax Shelters;
 - Information Reporting on Sales of Investments;
 - Withholding on Non-employee Compensation;
 - Document Matching;
 - Late Filed Returns;
 - Coordinated National Nonfiler Strategy;
 - Tip Agreements;
 - Fraud Prevention and Detection; and
- Increase Resources in the IRS Enforcement Functions.

Reduce the Complexity of the Tax Code

The topic of tax law complexity generally evokes calls for tax law simplification. Government, academic and technical studies suggest a strong correlation between tax law complexity and tax law compliance. The greatest case for the correlation is that complexity allows legal tax avoidance, which at times can evolve into illegal tax evasion. The argument continues that because of tax law complexity, it is often difficult to ascertain whether a taxpayer has intentionally evaded taxes, or whether there was an honest misunderstanding. Therefore, the IRS use of punitive penalties must be tempered to ensure taxpayers are not penalized for honest misunderstandings.

The President's Advisory Panel on Federal Tax Reform cited tax code complexity as a significant problem.¹⁷ Among others, sources of complexity include duplicative and overlapping provisions, phase-outs, and expiring provisions. In addition, the panel cited

¹⁷ The President's Advisory Panel on Federal Tax Reform, Complexity and Instability Staff Presentation (July 20, 2005).

the instability of the tax code. Since 1986, there have been more than 14,400 changes to the code. This complexity is costing the U.S. economy \$140 billion each year, with taxpayers spending over 3.5 billion hours preparing tax returns. More than 60 percent of all taxpayers now rely on a tax practitioner to prepare their tax returns.

One of the major effects attributed to tax law complexity is that it causes lower voluntary compliance. According to the American Institute of Certified Public Accountants, tax law complexity:

- Increases perceptions that the tax system is unfair;
- Increases costs for tax administration and tax compliance;
- Decreases the quality of tax administration and tax assistance; and
- Increases the number of inefficient economic decisions.¹⁸

Although it is believed that tax law simplification would increase voluntary compliance, there are significant factors that suggest simplification would be difficult to achieve throughout the Internal Revenue Code. The Joint Committee on Taxation identified various sources of complexity, with no single source as being primarily responsible. The sources identified were:

- A lack of clarity and readability of the law;
- The use of the Federal tax system to advance social and economic policies;
- Increased complexity in the economy; and
- The interaction of Federal tax laws with State laws, other Federal laws and standards (such as Federal securities laws, Federal labor laws and generally accepted accounting principles), the laws of foreign countries, and tax treaties.¹⁹

The lack of clarity and readability of the law results from:

- Statutory language that is, in some cases, overly technical and, in other cases, overly vague;
- Too much or too little guidance with respect to certain issues;
- The use of temporary provisions;
- Frequent changes in the law;
- Broad grants of regulatory authority;
- Judicial interpretation of statutory and regulatory language; and
- The effects of the congressional budget process.

Experts in tax policy maintain that any tax system will have complexity. Therefore, even though many people believe that tax simplification could provide the impetus for increasing voluntary compliance, a simple tax system could be a very difficult goal to

¹⁸ For example, inefficient economic decisions are made by taxpayers when they favor one activity over another because of the tax benefit or incentive.

¹⁹ Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(b) of the Internal Revenue Code of 1986.

achieve, given the complexities of our society and multiple uses of the Internal Revenue Code. Thus, closing the tax gap through tax simplification and eliminating tax expenditures could prove to be challenging. But, to the extent that the tax law can be simplified, most experts believe that voluntary compliance would improve.

Another effective method to increase voluntary compliance might be through greater visibility of transactions. A study by senior IRS researcher Kim M. Bloomquist suggests that beyond the tax law complexity/tax law compliance correlation there may be “trends in the environment that account for the rising tax noncompliance.”²⁰ According to the study, the presumed rise in tax noncompliance “may be due, at least in part, to a shift in taxpayer income away from more visible to less visible sources.” The study found that income that is not subject to third-party reporting is highest among taxpayers with the highest incomes.²¹ For the top 5 percent of taxpayers, unmatchable income as a percentage of Adjusted Gross Income increased by over 98 percent between 1980 and 2000.

The IRS has shown that there is a high correlation between tax compliance and third-party information reporting. The difference in compliance rates between individual wage-earning taxpayers and those operating businesses is striking. The IRS has estimated that individuals whose wages are subject to withholding report 99 percent of their wages for tax purposes.²² In contrast, self-employed individuals who formally operate non-farm businesses²³ are estimated to report only about 68 percent of their income for tax purposes. Even more alarming, self-employed individuals operating businesses on a cash basis²⁴ report just 19 percent of their income to the IRS.

TIGTA believes that a combination of efforts will be required to increase voluntary compliance and reduce the tax gap. Tax simplification and increased transparency through third-party reporting are significant contributing factors toward achieving these goals.

Gather Better Compliance Data

The IRS’ National Research Program (NRP) is designed to measure taxpayers’ voluntary compliance, better approximate the tax gap, and develop updated formulas to select

²⁰ Trends as Changes in Variance: The Case of Tax Noncompliance, June 2003.

²¹ Kim Bloomquist states that one of the shifts from matchable to unmatchable income was clearly caused by the stock market bubble of the late 1990’s. A prior shift was seen in from 1980 to 1995 due to the growth in small business income as a percentage of Adjusted Gross Income.

²² See General Accounting Office, *supra* note 7; Internal Revenue Service, Pub. 1415, Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992, (Rev. 1996).

²³ Formal, non-farm businesses are considered to be those that are typically not operated on a cash basis and that pay expenses such as taxes, rent, or insurance.

²⁴ These individuals provide products or services through informal arrangements that typically involve cash transactions or “off-the-books” accounting practices. This group includes child care providers, street vendors, and moonlighting professionals.

noncompliant returns for examination. The first phase of this program addressed reporting compliance for individual taxpayers, and data from this phase were used to produce the updated estimates of this portion of the tax gap. These initial findings should enable the IRS to develop and implement strategies to address areas of noncompliance among individual taxpayers. The next phase of the NRP, which has begun, focuses on Subchapter S corporations (Forms 1120S). TIGTA is currently conducting a review of this phase.

These initiatives will allow the IRS to update return-selection models for more effective return selection for its compliance efforts. In 2005, TIGTA reported that the return-selection formulas, developed in the 1980s, only accounted for the selection of 22 percent of the corporate returns selected for examination in FY 2004.²⁵ Updated selection models should contribute to more effective use of the IRS' compliance resources.

In April 2006, TIGTA recommended that the IRS Commissioner continue to conduct NRPs on a regular cycle for the major segments of the tax gap. TIGTA also recommended that the IRS augment the direct measurement approach, and devise indirect measurement methods to assist in quantifying the tax gap. The IRS agreed with these recommendations, subject to available resources. In addition, TIGTA recommended that the IRS Commissioner consider establishing a tax gap advisory panel that includes tax and economic experts to help identify ways to better measure voluntary compliance. The IRS agreed to look into establishing such an advisory group with the intent of using it to validate and improve estimation methods.

Refine Existing and Develop New Compliance Strategies

The IRS conducts various compliance activities in an effort to reduce the tax gap. However, the IRS needs to develop a comprehensive strategy to reduce the tax gap. Nearly 27 years ago, the GAO testified that "...it is clear that the Service [IRS] needs a comprehensive compliance strategy. To develop this, the IRS needs to determine the extent to which it is presently detecting unreported income from the various pockets of noncompliance. It then needs to consider reallocating its resources based on that determination and assess the need for additional resources to close the tax gap for each source of unreported income."²⁶

High-Income Taxpayers

Since FY 2000, the IRS' Small Business/Self-Employed (SB/SE) Division has increased examinations of potentially noncompliant high-income taxpayers. In FY 2005,

²⁵ *The Small Business/Self-Employed Division Is Beginning to Address Challenges That Affect Corporate Return Examination Coverage* (TIGTA Reference Number 2005-30-130, dated August 2005).

²⁶ Statement of Richard L. Fogel, Associate Director, General Government Division Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, September 6, 1979.

examinations of high-income taxpayers were at their highest level since FY 1996. As previously noted, the IRS considers high-income taxpayers to be those who file a U.S. Individual Income Tax Return (Form 1040) with Total Positive Income (TPI)²⁷ of \$100,000 or more and those business taxpayers who file a Form 1040 with Total Gross Receipts of \$100,000 or more on a Profit or Loss From Business (Schedule C) or on an attached Profit or Loss From Farming (Schedule F).

TIGTA recently reported the results of its review of the IRS' increased examination coverage rate²⁸ of high-income taxpayers.²⁹ The increased coverage has been due largely to an increase in correspondence examinations,³⁰ which limit the tax issues the IRS can address in comparison with face-to-face examinations. In addition, the compliance effect may be limited because over one-half of all high-income taxpayer examination assessments are not collected timely.

The examination coverage rate of high-income taxpayers increased from 0.86 percent in FY 2002 to 1.53 percent in FY 2005. Included in this statistic is an increase in the examination coverage rate of high-income tax returns, Forms 1040 with a Schedule C. This examination coverage rate increased from 1.45 percent in FY 2002 to 3.52 percent in FY 2005. However, as stated earlier, the increase in examination coverage is due largely to an increase in correspondence, rather than face-to-face, examinations. While face-to-face examinations increased by 25 percent from FY 2002 through FY 2005, correspondence examinations increased by 170 percent over the same period.

As a result, the percentage of all high-income taxpayer examinations completed through the Correspondence Examination Program grew from 49 percent in FY 2002 to 67 percent in FY 2005. The increase in correspondence examinations for high-income taxpayers who filed a Schedule C was even larger. Examinations closed by correspondence comprised about 30 percent of all high-income taxpayer Schedule C examinations from FY 2002 through FY 2004. In FY 2005, approximately 54 percent of all high-income taxpayer Schedule C examinations were conducted by correspondence.

High-income households typically have a large percentage of their income that is not subject to third-party information reporting and withholding. The absence of third-party information reporting and withholding is associated with a relatively higher rate of underreporting of income among business taxpayers. It is difficult to determine through

²⁷ Generally, the TPI is calculated by using only positive income values from specific income fields on the tax return and treats losses as a zero. For example, a hypothetical tax return filed with wages of \$90,000, interest of \$12,000, and a \$25,000 loss from an interest in a partnership would have a TPI totaling \$102,000 and be considered a high-income tax return by the IRS.

²⁸ The examination coverage rate is calculated by dividing the number of examined returns in a category by the number of returns in the same category filed in the previous year.

²⁹ *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* (TIGTA Reference Number 2006-30-105, dated July 25, 2006).

³⁰ Correspondence examinations are important compliance activities focusing on errors and examination issues that typically can be corrected by mail. They are conducted by sending the taxpayer a letter requesting verification of certain items on the tax return. These examinations are much more limited in scope than office and field examinations in which examiners meet face to face with taxpayers to verify information.

correspondence examination techniques whether these taxpayers have reported all of their income.

In FY 2004, the IRS assessed more than \$2.1 billion in additional taxes on high-income taxpayers through its Examination program. This figure includes assessments of \$1.4 billion (66 percent) on taxpayers who did not respond to the IRS during correspondence examinations. Based on a statistical sample of cases,³¹ TIGTA estimates that approximately \$1.2 billion³² (86 percent) of the \$1.4 billion has been either abated³³ or not collected after an average of 608 days — nearly two years after the assessment was made. Our conclusion is that the Examination and Collection programs for high-income taxpayers may not be positively affecting compliance, given the substantial assessments that have been abated or not collected.

TIGTA recommended that the IRS complete its plan to maximize the compliance effect of high-income taxpayer examinations. TIGTA also recommended that the plan should include the mixture of examination techniques, issues examined, and collection procedures. The IRS agreed with our recommendations.

Abusive Tax Shelters

The taxpaying public has long sought ways to minimize tax liabilities by sheltering income and gains from taxes through investments and other financial-related transactions. Some tax shelters, however, have received widespread publicity because they purportedly abuse the tax law, represent a significant loss of tax revenue, and undermine the public's confidence in the tax system. The Son of Boss³⁴ is one such abusive tax shelter. For this abusive tax shelter, the IRS estimated understated tax liabilities in excess of \$6 billion.

The IRS considers identifying and combating abusive tax shelters extremely important. This priority was reflected in the emphasis given to resolving the Son of Boss abusive tax shelter and ensuring a successful settlement initiative. The IRS publicly announced the settlement initiative in May 2004, and IRS management at all levels closely coordinated the initiative's implementation to ensure its success. A centralized office was established

³¹ TIGTA selected the sampled cases from those completed in FY 2004 to provide sufficient time for collection activities.

³² Margin of error \pm 5.05 percent.

³³ Abatement occurs when the IRS reduces an assessment, in this case from reversing examination findings that had uncovered apparent misreported income, deductions, credits, exemptions, or other tax issues.

³⁴ The Son of Boss (Bond and Option Sales Strategies) tax shelter was a highly sophisticated, technically complex, no-risk scheme designed to generate tax losses without corresponding economic risks. It was promoted by some prominent firms in the financial services industry to investors seeking to shelter large gains from the sale of a business or capital asset. The scheme used flowthrough entities, such as partnerships, and various financial products to add steps and complexity to transactions that had little or no relationship to the investor's business or the asset sale creating the sheltered gain. Additionally, the losses generated from the transactions were often reported among other "legitimate" items in several parts of the income tax return. Some losses, for example, were reported as a reduction to gross sales, cost of goods sold, or capital gains.

to receive investor application packages, where they were screened for suitability and forwarded to Examination function groups located throughout the country. Once the packages were received in the groups, examiners were assigned to validate the accuracy of the information on the investor application, determine the amount of out-of-pocket expenses³⁵ to allow, compute the amount of additional taxes owed, execute a closing agreement, and make arrangements with the investor to pay the taxes owed. Throughout the initiative, interim reports were prepared as a control mechanism to monitor progress and track the cases for both investors participating in the settlement and nonparticipating investors. As of March 16, 2005, IRS interim reports showed 1,039 participating investors had settled their cases by paying or agreeing to pay more than \$2.7 billion in taxes, interest, and penalties.

TIGTA reviewed the IRS' efforts and made two observations that the IRS may find useful.³⁶ First, experience demonstrated that the general three-year statutory assessment period was insufficient for tax administrators to examine and assess all identified participants in the Son of Boss abusive tax shelter. Although it is difficult to precisely estimate the fiscal impact of abusive tax shelters, State officials in California estimated losing between \$2.4 billion and \$4 billion over four years to various abusive tax shelters. They changed State income tax laws to give California tax administrators up to eight years to assess additional taxes related to abusive tax shelters. Steps were also taken in New York and Illinois to double statutory assessment periods from three years to six years.

At the Federal level where the loss from abusive tax shelters has been estimated at \$85 billion,³⁷ a provision in the American Jobs Creation Act of 2004 (AJCA)³⁸ provided the IRS with up to one additional year to assess taxes related to a "listed" transaction³⁹ if it is not properly disclosed on the return. Despite the positive, open-ended feature in the AJCA provision, an analysis of 1,958 income tax return examinations of investors in the Son of Boss abusive tax shelter found that the one-year extension does not accurately reflect the time needed to complete the examination and assessment process involved in resolving complex, technical abusive tax shelters. As a result, the one-year extension in the AJCA could prove overly restrictive to realizing intended benefits from the extended assessment period.

TIGTA also observed that another possible step the IRS could take is to plan for and conduct an assessment that captures the overall successes achieved and lessons learned in resolving the Son of Boss abusive tax shelter. Such an assessment could provide an

³⁵ Out-of-pocket expenses are transaction fees that were typically paid by investors to promoters.

³⁶ *The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters* (TIGTA Reference Number 2006-30-065, dated March 2006).

³⁷ *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters* (GAO-04-104T, dated October 2003).

³⁸ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

³⁹ A listed transaction is the same as or substantially similar to one of the types of transactions the IRS determined to be a tax avoidance transaction and identified by notice, regulation, or other form of IRS published guidance.

important tool for managers if they are again faced with a challenge of this magnitude. In addition, it would be in line with both the Government Performance and Results Act of 1993⁴⁰ and IRS guidance for analyzing program performance and identifying improvement options.

In addition, TIGTA recommended that the IRS determine whether the AJCA provision extending the statutory assessment period is adequate to protect tax revenues and deter participation in abusive tax shelters. TIGTA also recommended that the IRS evaluate and document its overall performance in resolving the Son of Boss abusive tax shelter. The IRS agreed with TIGTA's recommendation to evaluate its overall performance in resolving the Son of Boss abusive tax shelter. The IRS did not agree to take action to determine whether the AJCA provision extending the statutory assessment period is adequate for protecting tax revenues and deterring participation in abusive tax shelters. According to the IRS, more experience is needed before it can determine whether the one-year provision provided by the AJCA is adequate. The IRS may be missing an opportunity to further strengthen its ability to combat abusive tax shelters by not taking action on this recommendation.

Information Reporting on Sales of Investments

According to professors Joseph M. Dodge and Jay A. Soled,⁴¹ "An unpublicized problem of crisis proportions is plaguing the administration of the Internal Revenue Code, and it is costing the nation billions of dollars annually. The problem is neither hyper-technical nor hard to discern: On the sale of investments, taxpayers inflate their tax basis and do so with impunity, which results in the underreporting of gains and the overstatement of losses."⁴² In June 2006, the GAO reported that expanding the information brokers report on securities sales to include adjusted cost basis has the potential to improve taxpayers' compliance and help the IRS find noncompliant taxpayers.⁴³

The GAO estimates that 38 percent of individual taxpayers with securities transactions misreported their capital gains or losses in TY 2001. According to the GAO, roughly two-thirds of individual taxpayers underreported and roughly one-third overreported. About half of the taxpayers who misreported failed to accurately report the securities' cost or basis.

The lack of information on the basis of investments limits the effectiveness of IRS compliance efforts. Taxpayers report their income much more accurately when there is third-party reporting to the IRS. For the IRS, basis reporting would provide information to verify investment gains or losses, which would allow it to better focus enforcement

⁴⁰ Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

⁴¹ Joseph M. Dodge is the Stearns Weaver Miller Weissler Alhadeff & Sitterson Professor at Florida State University College of Law. Jay A. Soled is a professor at Rutgers University.

⁴² Joseph M. Dodge and Jay A. Soled, "Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question," Tax Notes, January 24, 2005.

⁴³ *Capital Gains Tax: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed* (GAO-06-603, dated June 2006).

resources on noncompliant taxpayers. Although basis reporting presents some administrative challenges, the GAO concluded that many of the challenges to implementing basis reporting could be mitigated.

Institute Withholding on Non-employee Compensation

Each year, over 40 percent (\$130 billion) of the total tax gap is attributable to underreporting among individuals with business income. More than 20 years ago, the GAO recommended that Congress consider requiring withholding and improving information returns reporting for independent contractors.⁴⁴ Two years ago, TIGTA recommended that the IRS initiate a proposal for a legislative change to mandate withholding on non-employee compensation payments, such as those provided to independent contractors.⁴⁵ Implementing such a provision could reduce the tax gap by billions of dollars.

The Joint Committee on Taxation made a proposal to implement withholding on payments from government entities.⁴⁶ The proposal recommended withholding 3 percent of payments to businesses and individuals (other than employees) providing goods and services to government entities. This proposal may be a good first step as it would provide an opportunity to test the feasibility and burden associated with such withholding.

In addition to implementing withholding on non-employee compensation, other actions should be taken to improve compliance among independent contractors. For example, improvement is needed to address inaccurate reporting of Taxpayer Identification Numbers (TINs) for independent contractors. For TY 1995 through TY 1998, the IRS received about 9.6 million statements for Recipients of Miscellaneous Income (Forms 1099-MISC), reporting approximately \$204 billion in non-employee compensation that either did not contain a TIN or had a TIN that did not match IRS records.

For any person required to provide a TIN to the IRS, permitting disclosure about whether such information matches records maintained by the IRS might help improve the accuracy of TINs.⁴⁷ This would allow a payor to verify the TIN furnished by a payee prior to filing information returns for reportable payments. Additionally, withholding could be mandated for independent contractors who fail to furnish a TIN. Implementing mandated withholding for this segment of independent contractors would result in an estimated \$2.2 billion in increased revenue to the IRS each year.

⁴⁴ Statement of Richard L. Fogel, Associate Director, General Government Division before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, September 6, 1979.

⁴⁵ *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* (TIGTA Reference Number 2004-30-040, dated February 2004); *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* (TIGTA Reference Number. 2001-30-132, dated August 2001).

⁴⁶ Staff of the Joint Committee on Taxation, 109th Cong., *Options to Improve Tax Compliance and Reform Tax Expenditures* (Comm. Print 2005).

⁴⁷ S. 1321, Telephone Excise Tax Repeal Act Of 2005.

Document Matching

TIGTA has also identified improvements that should be made to improve compliance in business tax filing.⁴⁸ The GAO reported that more than 60 percent of U.S.-controlled corporations and more than 70 percent of foreign-controlled corporations did not report tax liabilities from 1996 through 2000.⁴⁹ Although individual wage earners who receive a Wage and Tax Statement (Form W-2) have their wages verified through a matching program, a similar comprehensive matching program for business documents received by the IRS does not exist. TIGTA has recommended that the IRS evaluate all types of business documents it receives to determine whether this information can be used to improve business compliance. In its response to our recommendations, the IRS wrote that it could not implement this recommendation at that time. However, the IRS also shared its belief that ongoing efforts would provide the results that our recommendation hoped to achieve and asked for the opportunity to continue its efforts.

An IRS study, based on TIGTA recommendations, found that in FY 2000, business information documents⁵⁰ reported \$697 billion in potential taxable income.⁵¹ Furthermore, business information documents identified 1.2 million unresolved IRS business nonfiler tax modules. An IRS tax module contains records of tax liability and accounting information pertaining to one type tax for one reporting period. TIGTA has also reported on issues related to the increasing global economy. Investments made abroad by U.S. residents have grown in recent years, nearly tripling from \$2.6 trillion in 1999 to \$7.2 trillion in 2003. To address the tax compliance challenges presented by foreign investments, TIGTA recommended that the IRS make better use of the foreign-source income information documents received from tax treaty countries. TIGTA also recommended that prior to issuing refunds to foreign partners, the IRS implement an automated crosscheck of withholding claims against available credits for partnerships with foreign partners.⁵²

⁴⁸ *The IRS Should Evaluate the Feasibility of Using Available Documents to Verify Information Reported on Business Tax Returns* (TIGTA Reference Number 2002-30-185, dated September 2002).

⁴⁹ General Accounting Office, Pub. No. GAO-04-358, TAX ADMINISTRATION: Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000 (2004).

⁵⁰ The IRS receives over 30 different types of business information documents yearly. Most of these forms have a legal requirement for issuance to corporations. The three information documents most often issued to business nonfilers are Forms 1099-B (Proceeds from Broker and Barter Exchange Transactions), 1099-MISC (Miscellaneous Income), and 4789 (Currency Transaction Reports).

⁵¹ Internal Revenue Service, Report of BMF IRP Nonfilers for TY 2000 (Corporations, Partnerships, and Trusts), Research Project 02.08.003.03, SB/SE Research (July 2004).

⁵² *Stronger Actions Are Needed to Ensure Partnerships Withhold and Pay Millions of Dollars in Taxes on Certain Income of Foreign Partners* (TIGTA Reference Number 2001-30-084, dated June 2001); *Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data* (TIGTA Reference Number 2005-30-101, dated July 2005).

Implementing a comprehensive matching program to identify noncompliance among businesses would be difficult and could require some legislative changes, but it could identify significant pockets of noncompliance among business taxpayers.

Late Filed Returns

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

In 1993, IRS management eliminated the requirement to pay all taxes by the payment due date in order to qualify for an extension of time to file. Once an extension has been granted, the taxpayer is exempt from a 5 percent per month delinquency penalty⁵³ for the period of the extension. TIGTA evaluated the impact of these rules on individual and corporate taxpayers and found that 88 percent of untimely tax payments for returns filed after April 15 were attributable to extended-due-date taxpayers.⁵⁴ Corporations are required to pay estimates of their unpaid taxes in order to be granted extensions. However, TIGTA found corporate estimates to be highly flawed; in calendar year (CY) 1999 alone, approximately 168,000 corporations received an extension, yet failed to pay \$1.8 billion in taxes when they were due.

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

Coordinated Nonfiler Strategy

According to the IRS' February 2006 tax gap map, individual and estate tax non-filers accounted for about 8 percent of the total tax gap⁵⁵ for TY 2001. Corporate income, estate and excise tax non-filing estimates were not available. The IRS study, together

⁵³ The Delinquency Penalty is also known as the Failure-to-File Penalty, although it only applies to taxpayers who both file late and fail to pay all taxes by the tax payment deadline.

⁵⁴ *The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers* (TIGTA Reference Number 2003-30-162, dated August 2003); *Changes to the Regulations for Granting Extensions of Time to File Corporate Returns Are Needed to Alleviate Significant Problems With Administering the Tax Laws* (TIGTA Reference Number 2004-30-106, dated June 2004).

⁵⁵ The non-filer tax gap is the dollar amount of taxes not paid timely on delinquent and non-filed returns.

with previous IRS studies, indicates that the tax gap for individual non-filers almost tripled from \$9.8 billion in TY 1985 to about \$27 billion⁵⁶ in TY 2001.

In the past, the IRS has had several strategies for reducing the tax gap attributable to individual non-filers. The most recent National Non-filer Strategy, which was developed for FY 2001 through FY 2003, was made obsolete in July 2002 when the IRS was reorganized. Since then, each IRS business division has been responsible for tracking and monitoring completion of its own action items. Consequently, there has been no formal system in place for coordinating and tracking all actions across all IRS divisions.

In November 2005, TIGTA reported that as increasing voluntary compliance remains a service-wide effort, the individual business divisions within the IRS have taken steps to improve efficiency in working non-filer cases.⁵⁷ The actions taken by the business divisions included:

- Consolidation of the Automated Substitute for Return Program⁵⁸ into one campus;⁵⁹
- Computer programming changes to enhance automated processing of returns created by the IRS for non-filing businesses, as authorized under Section 6020(b) of the Internal Revenue Code;⁶⁰
- Refinement of the processes for selection and modeling of non-filer cases each year through risk-based compliance approaches. The intention is to identify and select the most productive non-filer work and to apply appropriate compliance treatments to high-priority cases;
- Increased outreach efforts by the SB/SE Division through its Taxpayer Education and Communication function; and
- An increase in the number of cases recommended for prosecution by the Criminal Investigation Division from 269 in FY 2001 to 317 in FY 2004 (an increase of 17.8 percent).

⁵⁶ The estimated tax gap of \$27 billion in TY 2001 was composed of \$25 billion for individual income tax non-filing and \$2 billion associated with estate and gift tax. The estimate is developed from other tax gap data sources and is not derived from direct data sources. So, the growth in the dollar amounts in the estimate track the increases in other tax gap estimates.

⁵⁷ *The Internal Revenue Service Needs a Coordinated National Strategy to Better Address an Estimated \$30 Billion Tax Gap Due to Non-filers* (TIGTA Reference Number 2006-30-006, dated November 2005).

⁵⁸ The Automated Substitute for Return Program focuses on high-income taxpayers who have not filed individual income tax returns but appear to owe significant income tax liabilities based on available Information Reporting Program information.

⁵⁹ The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

⁶⁰ Internal Revenue Code Section 6020(b) (2005) provides the IRS with the authority to prepare and process certain returns for a non-filing business taxpayer if the taxpayer appears to be liable for the return, the person required to file the return does not file it, and attempts to secure the return have failed.

However, these were not coordinated activities that were planned and controlled within the framework of a comprehensive strategy. Since FY 2001, each business division has independently directed its own non-filer activities. The IRS did not have a comprehensive, national non-filer strategy or an executive charged with overseeing each business division's non-filer efforts. TIGTA concluded that the IRS needed better coordination among its business divisions to ensure that resources are being effectively used to bring non-filers into the tax system and ensure future compliance. The IRS also needed an organization-wide tracking system to monitor the progress of each business division's actions.

In addition to better coordination and an organization-wide tracking system, the IRS also needed measurable program goals. TIGTA suggested three measurable goals that could be established:

- The number of returns secured from non-filers;
- Total payments received; and
- The recidivism rate.

Without such measurable program goals, the IRS is unable to determine whether efforts to improve program efficiency and effectiveness are achieving desired results. The IRS agreed with all of TIGTA's recommendations. For FY 2006, the IRS developed its first comprehensive non-filer work plan.

Tip Agreements

The IRS has historically been concerned with employees not reporting tips earned in industries in which tipping is customary. An IRS study showed that the amount of tip income reported in CY1993 was less than one-half of the tip income amount, leaving more than \$9 billion in unreported income. As a result, the IRS developed the Tip Rate Determination and Education Program (the Tip Program), which is a voluntary compliance program originally developed in 1993 for the food and beverage industry. It was modeled after the tip compliance agreement used by casinos in the former IRS Nevada District. The Tip Program was extended to the cosmetology industry in 1997 and the barber industry in 2000. Since the Tip Program was introduced, voluntary compliance has increased significantly. In TY 1994, tip wages reported were \$8.52 billion. For TY 2004, the amount exceeded \$19 billion. To date, over 16,000 employers, representing over 47,000 individual establishments, have entered into tip agreements.

Participation in a tip agreement provides benefits for both employees and employers. Assuming that the employer recognizes higher income, employees would be eligible for greater Social Security income, increased unemployment benefits, and workers' compensation. The increased income would also improve opportunities for approval when applying for loans. If the employer has a retirement contribution plan, there may be additional funding for employees. Once an employee signs a participation agreement, the employee will not be audited on future tips above the agreed tip rate during the

agreement period. If an employee does not sign a participation agreement with an employer that has an agreement, the employee will be subject to a possible audit.

In May 2001, we issued a report on the Tip Program.⁶¹ Results showed that, while the amount of tip income reported to the IRS had consistently increased, additional enhancements could be made to increase compliance. We recommended that the IRS reemphasize the Tip Program's importance, provide adequate oversight, ensure proper transfer of the Tip Program from the Employment Tax Compliance function to the new Taxpayer Education and Communication (TEC) function, and expand the Tip Program to other industries in which tipping is customary.

We recently followed up on our May 2001 report.⁶² Due to the voluntary nature of participation and limited staffing resources, disparity over the number of tip agreements secured in various locations across the country continues to be an issue. The IRS does not plan to actively solicit any new tip agreements beyond the gaming industry in FY 2006. The majority of FY 2006 Tip Program staffing will solicit and monitor tip agreements with the gaming industry and examinations of casino employees. Additionally, multiple realignments affected the transition of the outreach portion of the Tip Program from the Compliance function to the Taxpayer Education and Communication function. The Tip Program has not expanded to the taxi/limousine industry.

The IRS has not yet established an automated system to identify business entities required to file an Employer's Annual Information Return of Tip Income and Allocated Tips (Form 8027).⁶³ The IRS recently manually matched the Employer's Quarterly Federal Tax Return (Form 941) data to the database of TY 2004 Forms 8027, identifying 33,685 employers as potential Form 8027 non-filers. However, the Form 8027 database data fields are not always accurate, and only the first quarter of TY 2004 Forms 941 have been matched to this database. Identification of Form 941 non-filing was not prioritized.

The IRS has automated the tracking of tip agreements for the food and beverage and cosmetology industries. This automated database is part of a system that is not fully operational but is now funded with a tentative date of FY 2008 for full implementation. However, the gaming tip agreements are maintained in a separate database that does not accommodate all necessary information, preventing consistent use of the information. Also, the Tip Program does not reach some small businesses in the food and beverage industry. The IRS has developed a Revenue Procedure to address this, which the Department of the Treasury approved on July 11, 2006. The IRS plans to test it for three years. A similar Revenue Procedure is needed for small businesses in other industries.

⁶¹ *Opportunities Exist to Improve the Tip Rate Education and Determination Program* (Reference Number 2001-30-076, dated May 2001).

⁶² *Additional Enhancements Could Improve Tax Compliance of Employees Who Receive Tips* (Reference Number 2006-30-132, dated September 15, 2006).

⁶³ Form 8027 is an information return filed by large Food and Beverage establishments when the employer is required to make annual reports to the IRS on receipts from food or beverage operations and tips reported by employees. Generally, a large employer is one who employs more than 10 employees on a typical business day.

We recommended that the IRS ensure that adequate staffing remains available for monitoring tip agreements for all industries and use the results of monitoring to measure compliance; prepare a workforce plan to determine the necessary staffing levels needed to accomplish the Tip Program's goals; ensure the automated tracking system remains funded and, once fully operational, includes the gaming industry tip agreements. After the Revenue Procedure is tested with the food and beverage industry for one year, we recommended that the IRS consider developing a similar Revenue Procedure for small businesses in other industries. IRS management agreed with our recommendations.

In another audit, we determined that since the IRS' Indian Tribal Government (ITG) Office became operational in FY 2001, the IRS had entered into only 16 agreements with tribal entities for voluntarily reporting casino tip income and had asserted some liabilities on tribal casinos under I.R.C. Section (§) 3121(q).⁶⁴ In FY 2001, the ITG Office identified tip reporting as a major compliance issue for tribal governments because of the increase in tribal gaming revenue and because the IRS previously had not had a coordinated effort to interact with tribal governments to ensure compliance with the I.R.C.

Although the ITG Office has taken significant actions to improve voluntary compliance by tribal employers and employees, some entities have declined tip rate agreements. We could not determine the impact of the ITG Office's actions to enforce compliance with I.R.C. §§ 3121(q) and 3401(f)⁶⁵ for those entities not voluntarily entering into tip agreements or entities not adhering to the terms of signed agreements. Most enforcement actions started by the ITG Office were still ongoing at the conclusion of our audit. Specifically, since the beginning of FY 2005, the ITG Office had initiated tip examinations related to 13 tribal entities but had completed examinations for only 3 of them. In addition, the ITG Office has not revoked any of the tip agreements between the IRS and tribal gaming entities and has not assessed any liabilities under I.R.C. § 3121(q), which was assigned to the ITG Office in June 2006 for tribal customers.⁶⁶ We did not make any recommendations in our report.

Fraud Prevention and Detection

The Criminal Investigation (CI) Division's Questionable Refund Program is a nationwide program established to detect and stop fraudulent claims for refunds on income tax returns. The Electronic Fraud Detection System (EFDS) is the primary information

⁶⁴ *The Indian Tribal Governments Office's Administration of the Tip Compliance Program for Its Customer Base Increased Voluntary Compliance* (Reference Number 2006-10-131, dated September 8, 2006). I.R.C. § 3121(q) (2005) allows the IRS to assess the employer's share of taxes with respect to unreported tips under the Federal Insurance Contribution Act, I.R.C. §§ 3101-3128.

⁶⁵ I.R.C. § 3401(f) (2005) relates to tips received by employees in the definition of "wages" for purposes of employment taxes.

⁶⁶ If it is determined that a tribe is not adhering to the terms required in its tip agreement, revocation of that agreement should be considered. Because participation in the Tip Program is voluntary, revocation should be a last resort.

system used to support the Questionable Refund Program. In 2001, a contractor was hired to assist the IRS with EFDS operations, maintenance, and enhancements. As of April 24, 2006, more than \$37 million had been paid to the contractor for this work, including \$18.5 million for system development efforts. Two other contractors were paid approximately \$2 million for system development work, bringing the total EFDS system development cost to \$20.5 million. The January 31, 2006, business case shows that the EFDS total costs from August 1994 through September 2005 were \$185.9 million.

In 2002, the IRS initiated an effort to redesign the EFDS to improve system performance, reliability, and availability. The redesigned EFDS web-based application (Web EFDS) was to be implemented in January 2005. Due to system development problems, the implementation date was delayed until January 2006. However, the implementation date was not met. On April 19, 2006, all system development activities for the Web EFDS were stopped, and all efforts were focused on restoring the old EFDS for use in January 2007. Therefore, the IRS was unable to use the EFDS to prevent fraudulent refunds during the 2006 Filing Season. The IRS reported that due to other leads, \$93.9 million in fraudulent refunds had been stopped as of May 19, 2006, without the EFDS being operational. While the precise amount of fraudulent refunds is unknown, the IRS reported that more than \$412 million in fraudulent refunds had been stopped in 2005.⁶⁷

Increase Resources in the IRS Enforcement Functions

In September 1979, the GAO testified before Congress that “The staggering amount of income, at least \$135 billion, on which taxes are not paid is shocking.”⁶⁸ The GAO’s testimony focused on actions the Government should take. The recommended actions included ensuring that the level of the IRS’ audit activity did not decline. Unfortunately, while there have been periods of increases in compliance staffing, the IRS has also experienced declines over the years.

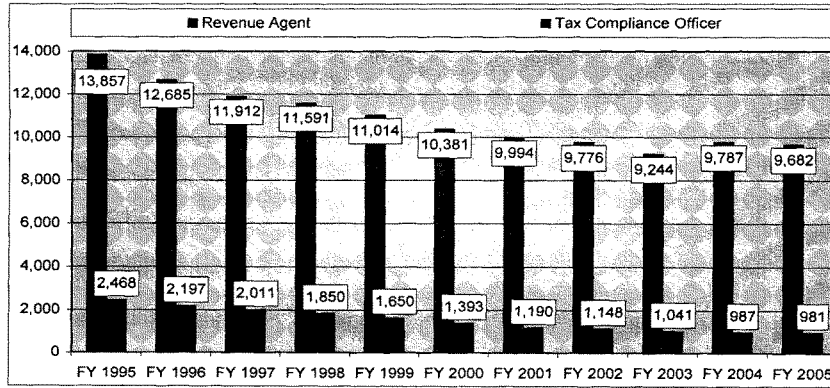
The combined Collection and Examination functions enforcement personnel⁶⁹ declined from approximately 22,200 at the beginning of FY 1996 to 14,500 at the end of FY 2005, a 35 percent decrease. While the President’s FY 2007 proposed budget for tax law enforcement is a slight increase over the FY 2006 budget, the additional funding may not be sufficient to increase enforcement activity above the level provided in the FY 2006 budget. Even though the IRS has started to reverse many of the downward trends in compliance activities, the Collection and Examination functions’ enforcement staffing level is not much higher than the 10-year low experienced in FY 2003.

⁶⁷ *The Electronic Fraud Detection System Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified* (Reference Number 2006-20-108, dated August 9, 2006).

⁶⁸ Statement of Richard L. Fogel, Associate Director, General Government Division before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, September 6, 1979.

⁶⁹ Collection and Examination function staff located in field offices, excluding management and overhead staff.

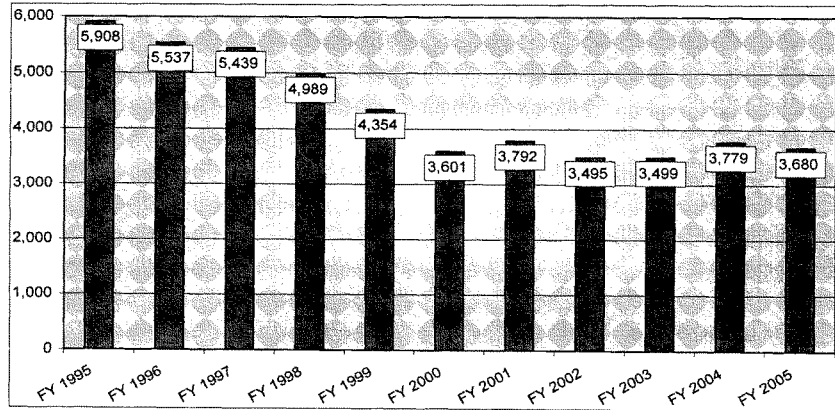
Figure 4: Examination Staffing



Source: TIGTA analysis of IRS' Audit Information Management System Table 37

The numbers in the preceding chart represent the number of Examination function staff conducting examinations of tax returns, excluding management and overhead staff. During FY 2005, revenue agent and tax compliance officer (formerly referred to as tax auditor) staffing decreased, and the combined total is now nearly 35 percent lower than it was at the beginning of FY 1996.

Figure 5: Collection Function Staffing



Source: IRS Collection Reports

The numbers in the preceding chart represent the Collection Field function staffing at the end of each FY 1995 through 2005. The number of revenue officers working assigned

delinquent cases, excluding management and overhead staff, decreased slightly during FY 2005 and is nearly 38 percent fewer than at the start of FY 1996.

One effect of the lack of resources in the Collection function is that the Queue,⁷⁰ has increased significantly since FY 1996. In FY 1996, the Queue contained more than 317,000 balance-due accounts worth \$2.96 billion. In FY 2004, these figures had increased to over 623,000 balance-due accounts worth \$21 billion. Additionally, the number of unfiled tax return accounts in the Queue increased from over 326,000 in FY 1996 to more than 838,000 in FY 2004.

The number of balance-due accounts “shelved,” or removed from the Queue altogether because of lower priority, has also increased significantly. In FY 1996, less than 8,000 of these balance-due accounts were shelved, but in FY 2004, more than 1 million of these accounts were removed from inventory. From FY 2001 to FY 2004, approximately 5.4 million accounts with balance-due amounts totaling more than \$22.9 billion were removed from Collection function inventory and shelved. Additionally, in FY 2004 alone, more than 2 million accounts with unfiled returns were shelved.⁷¹

If increased funds for enforcement are provided to the IRS in upcoming budgets, the resource issues in the enforcement functions will be addressed to some degree. In addition, use of private collection agencies should allow the IRS to collect more outstanding taxes. The IRS will have to be vigilant in overseeing these contractors to ensure that abuses do not occur. However, past experiences with lockbox thefts and insufficient contractor oversight provide valuable lessons toward reducing the likelihood of similar issues occurring when contracting out collection of tax debt.⁷²

Overseeing the IRS’ private debt-collection initiative is a top priority for TIGTA. TIGTA has coordinated with the IRS during the initial phases of implementation of this initiative by addressing security concerns with the contracts and protection of taxpayer rights and privacy, and by developing integrity and fraud awareness training for the contract employees. TIGTA has also developed a three-phase audit strategy to monitor this initiative and provide independent oversight.

There are many areas in which increased enforcement and/or legislative remedies could address noncompliance. For example, a TIGTA audit found that a significant number of single shareholder owners of Subchapter S corporations avoided paying themselves

⁷⁰ An automated holding file for unassigned inventory of lower priority delinquent cases that the Collection function does not have enough resources to immediately assign for contact.

⁷¹ *High-Risk Work Is Selected From the Unassigned Delinquent Account Inventory, but Some Unassigned Accounts Need Management’s Attention* (Reference Number 2006-30-030, dated February 2006).

⁷² *Federal Requirements Need Strengthening at Lockbox Banks to Better Protect Taxpayer Payments and Safeguard Taxpayer Information* (TIGTA Reference Number 2002-30-055, dated February 2002); *Insufficient Contractor Oversight Put Data and Equipment at Risk*, (TIGTA Reference Number 2004-20-063, dated March 2004).

salaries to avoid paying employment taxes.⁷³ We estimated this would cost the Treasury approximately \$60 billion in employment taxes over five years. Under current law, the IRS must perform an examination of these taxpayers to determine reasonable compensation. To accomplish this on any scale would require significant compliance resources.

Additional resources might also help the IRS address the growth in fraudulent returns filed by incarcerated individuals. On June 29, 2005, I testified before the House Committee on Ways and Means' Subcommittee on Oversight about this growing problem.⁷⁴ Although prisoner tax returns account for only 0.43 percent of all refund returns, they account for more than 15 percent of the fraudulent returns identified by the IRS. Refund fraud committed by prisoners is growing at an alarming rate. The number of fraudulent returns filed by prisoners and identified by the IRS' Criminal Investigation function grew from 4,300 in processing year (PY) 2002 to more than 18,000 in PY 2004 (a 318 percent increase).⁷⁵ During that same period, all fraudulent returns identified grew by just 45 percent.

The IRS' Fraud Detection Centers screen tax returns based on criteria that identify potentially fraudulent filings. The number of returns screened is based on these criteria and the available resources. During PY 2004, Fraud Detection Centers screened about 36,000 of the approximately 455,000 refund returns identified as filed by prisoners. Resources were not available to screen the remaining 419,000 tax returns. Those returns claimed approximately \$640 million in refunds and approximately \$318 million of Earned Income Tax Credit (EITC). For those unscreened returns, over 18,000 prisoners incarcerated during all of CY 2003 filed returns with a filing status as "Single" or "Head of Household" and claimed more than \$19 million in EITC. Since prisoners were incarcerated for the entire year, they would have had neither eligible earned income to qualify for the EITC nor a qualified child who lived with them for more than six months.

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

⁷³ *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations* (TIGTA Reference Number 2005-30-080, dated May 2005).

⁷⁴ *Hearing to Examine Tax Fraud Committed by Prison Inmates*, 109th Cong. (2005) (statement of J. Russell George, Inspector General) and *The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners* (TIGTA Reference Number. 2005-10-164, dated September 2005).

⁷⁵ Processing year refers to the year in which taxpayers file their returns at the Submission Processing Sites. Generally, returns for 2003 were processed during 2004, although returns for older years were also processed.

Conclusions

It is unlikely that a massive change in voluntary and timely compliance can be achieved without significant changes to the tax administration system. The IRS faces formidable challenges in completely and accurately estimating the tax gap and finding effective ways to increase voluntary compliance. Strategies have been identified to decrease the tax gap and improvements can be realized; however, sufficient resources are needed to ensure compliance with the tax laws.

Mr. Chairman and members of the subcommittee, I appreciate the opportunity to share my views on uncollected taxes and transparency and the work TIGTA has done in this area. I would be happy to answer any questions you may have.

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**Written Statement of
Nina E. Olson
National Taxpayer Advocate**

Before the

**Subcommittee on Federal Financial Management, Government Information,
and International Security**

**Committee on
Homeland Security and Governmental Affairs
Committee on Finance**

United States Senate

Hearing on

The Tax Gap

September 26, 2006

Mr. Chairman, Senator Carper, 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 five 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 Finance Subcommittee on Taxation and IRS Oversight (7/26/2006); 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.

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. Equally important, the designation of errors as either "intentional" or "inadvertent" is insufficient to enable the IRS to refine its tax gap strategy. Consider, for example, a taxpayer who purchased shares in a mutual fund 10 years ago and elected to have periodic capital gain and dividend distributions automatically invested in the fund. If the taxpayer sells his holding and does not have adequate records of all the automatic reinvestments that occurred over his 10-year holding period, it will be very challenging for the taxpayer to reconstruct his basis in the fund. If the taxpayer makes an educated guess that his basis has increased to about \$1500, he is "intentionally" reporting a number that he knows is not correct. But that sort of "intentional" error which a taxpayer commits to approximate the correct result is very different from a decision by a business owner dealing in cash to fail to report income. In the next phase of the National Research Program, the IRS should seek to refine its determinations of the sources of noncompliance to measure and distinguish between these types of intentional misreporting. A more refined understanding of the causes of noncompliance would enable the IRS to develop a more refined and cost-effective compliance strategy.

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.⁵ 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.⁶ The IRS therefore has an equal duty to address errors of

⁵ 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).

⁶ 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).

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 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.⁷ 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.⁸

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

⁷ 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).

⁸ 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).

revising forms, improving the Electronic Funds Transfer Payment System (discussed below), and answering tax law questions, has a positive indirect effect on compliance.⁹

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.¹⁰ In the absence of better research, decisions about how to allocate IRS resources are being based largely on hunches and slightly educated guesses.¹¹

Although the responsibility for conducting most research rests with the core IRS research function, TAS's research function is conducting several studies, some in conjunction with the core IRS research function, that could lead to improved tax reporting accuracy. I will briefly highlight five: a study of how abusive tax schemes spread; a study seeking to quantify the downstream costs of IRS compliance initiatives; participation in development of a "Taxpayer Assistance Blueprint" requested by the Senate Appropriations Committee; a study of the impact of representation on the outcome of EITC audits; and a study to learn more about barriers that impede the ability of some taxpayers to respond effectively if they are audited.

Abusive Tax Schemes – The "Tipping Point" Study

TAS is sponsoring research conducted by the IRS Office of Program Evaluation and Risk Analysis (OPERA) to identify what the IRS is doing to detect and combat emerging abusive tax schemes, such as abusive tax shelters and the slavery reparations scheme, and to investigate alternative approaches to enhance evaluation of schemes and possible treatments. OPERA engaged a contractor to create a behavioral model of participants in abusive schemes. Agent-based modeling was used to simulate taxpayer behavior in social networks – specifically, the model simulated the spread of information about the scheme and taxpayers' decisions to participate or not participate. A model was developed to simulate the dissemination of the home-based business scheme in

⁹ 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).

¹⁰ 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).

¹¹ 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).

two US cities and a trusts scheme in a third city. Results from the model are promising. The model was able to accurately represent the underlying populations of the three cities, and dissemination appeared to occur in a reasonable fashion (*i.e.*, in accordance with our expectations). The model also facilitated “what if” analysis. Variables can be changed, and the model can be rerun to test the impact of the changes on results.

Work on the next project phase is scheduled to begin in October. We will meet with researchers at Carnegie Mellon University to explore methods for validating the agent-based modeling approach. Our objective is to create a model that the IRS can use, as it learns of each new scheme, to determine which steps would be most effective in stopping the scheme’s further spread.

Downstream Effects of Compliance Initiatives

TAS Research completed a profile of TAS’s workload to facilitate analysis of the downstream costs of IRS compliance measures. We also developed preliminary models of the ten largest categories of TAS receipts, which collectively comprise more than 50% of TAS’s total workload. We are currently perfecting these models. Our goal is to have final models ready for review by W&I Research and SB/SE Research by the end of September. Next, we plan to aggregate the remaining categories into a small number of groups for which we will develop additional models. While the impetus for this research was to enable TAS to better project future case receipts based on IRS Operating Division work plans, the research can be used to estimate the additional costs TAS will incur to work cases resulting from IRS enforcement initiatives. All IRS compliance initiatives have “downstream costs” associated with them (*e.g.*, TAS assistance, audit reconsideration proceedings, collection actions on unpaid assessments, administrative appeals, and sometimes litigation), and accurate return-on-investment calculations must reflect these costs. This study will help us get a better handle on one of the downstream costs.

Taxpayer Assistance Blueprint

Acknowledging the impact taxpayer service has on compliance, Congress directed the IRS, the IRS Oversight Board, and the National Taxpayer Advocate to develop a 5-year plan for taxpayer service that includes long-term goals that are strategic and quantitative and that balance enforcement and service. Representatives from TAS Research are working with the Taxpayer Assistance Blueprint (TAB) team to review existing research and to develop and implement a research plan. Our goal is to ensure that IRS customer service plans are based on a thorough understanding of the needs and preferences of our diverse taxpayer population.

The TAB team completed Phase I, and is working to validate service improvement themes identified in Phase I by collecting more primary source data and by analyzing how well our current level and types of services are serving different taxpayer segments. Several research studies within the TAB are designed to measure the impact of customer service activities on compliance. Much of the validation research

will be completed during the fourth quarter of FY 2006, and the TAB team then will prepare a report summarizing its findings and future research plans.

Impact of Representation on the Outcome of EITC Audits

TAS Research analyzed a sample of 50 tax year 2002 returns and verified that the Centralized Authorization File (CAF) is an effective indicator of taxpayers who had representation during their audits. We subsequently requested and received population data for tax year 2002 taxpayers with representation, and will begin analysis of the data in August. Our goal, by the end of the year, is to determine whether representation has an effect on the outcome of EITC audits. A finding that representation increases the likelihood that a taxpayer will prevail would suggest that other EITC audits without taxpayer representation are being unduly decided against the taxpayer. Changes in the audit process to improve the accuracy of the outcome would reduce the tax gap by limiting incorrect audit assessments and possibly enabling the IRS to redirect its limited audit resources to areas of greater non-compliance.

Barriers to Taxpayer Participation in Audits

TAS Research is conducting a survey to study barriers that make it difficult for taxpayers to participate effectively in responding to an audit. The objective of this study is similar to the objective of the ETIC audit study – namely, to improve the accuracy of the audit process and possibly improve case selection.

There is one additional significant undertaking in which the TAS Research function is involved. Over the past three years, I have put forward a number of proposals to increase compliance in 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 my recommendations and recommendations made by others. TAS’s director of research is serving as the co-chair of the task force. The task force is described in more detail in Section III.E. below.

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 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.¹² 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.¹³ 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).¹⁴ In June 2005, however, the Government Accountability Office (GAO) concluded that the TPI was "an inaccurate indicator of a taxpayer's ability to pay."¹⁵ Soon thereafter, the IRS

¹² The Federal Payment Levy Program is authorized by IRC § 6331(h).

¹³ National Taxpayer Advocate 2005 Annual Report to Congress 124-130.

¹⁴ TPI was based on information taken from the taxpayer's last filed tax return and was calculated by adding 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).

¹⁵ General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures, Performance and Equity Can Be Improved* 11 (March 6, 2003).

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 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.¹⁶ 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.¹⁷

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.

¹⁶ Taxpayer Advocate Management Information System (TAMIS) data (FY 2006 through June 30, 2006).

¹⁷ 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.

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 2005.¹⁸

Many states and localities impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts.¹⁹ The IRS should consider 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.²⁰ 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

¹⁸ 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).

¹⁹ 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> (requiring contractors to obtain different contractor license classes based on the value of the contractors' jobs).

²⁰ See National Taxpayer Advocate 2004 Annual Report to Congress, Vol. II, *Earned Income Tax Credit (EITC) Audit Reconsideration Study*.

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.

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.²¹ Where taxable payments are not reported to the IRS by third parties, compliance drops precipitously, probably below 50 percent.²² 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.²³

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:

²¹ See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

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

²³ 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.”).

- 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.²⁴
- Over 80 percent of all individual underreporting is attributable to understated income rather than overstated deductions.²⁵

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.²⁶

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.

²⁴ 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).

²⁵ See 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).

- 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 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, probably below 50 percent. 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 *payor* of that income? After all, the payor 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.²⁷

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 eBay sales constitute their primary or secondary source of income.²⁸ 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

²⁷ 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.

²⁸ John Cassidy, *Going Long*, *The New Yorker*, July 10 & 17, 2006, at 99 (citing an AC Nielsen study).

area are difficult to come by, but two professors have sized the problem at about \$25 billion a year.²⁹ 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.³⁰

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

²⁹ Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question*, 106 Tax Notes 453 (Jan. 24, 2005).

³⁰ Congress could consider providing brokers with a one-time credit to offset the cost of implementing a comprehensive basis-tracking system.

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.³¹ Similarly, the 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.³² The letters should also offer to accept estimated payments monthly or even bi-weekly, just like most other recurring bills.³³ 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.

³¹ 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.*

³² 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.

³³ Some mortgage companies offer programs that electronically deduct mortgage payments bi-weekly rather than monthly.

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.³⁴ 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 not issued 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.

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.³⁵ 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.³⁶ 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.³⁷ 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;³⁸ 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.³⁹ Thus, many taxpayers who would otherwise be

³⁴ H.R. Conf. Rep. No. 105-599.

³⁵ *Tax Increase Prevention & Reconciliation Act of 2005*, § 509 (amending section 7122 of the Internal Revenue Code).

³⁶ 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).

³⁷ 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).

³⁸ IRC § 72(t).

³⁹ SBI/SE, *Offer in Compromise Program, Executive Summary (FY 2006 (through April 30, 2006))*.

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.

For most Americans, the annual rite of preparing and filing their tax returns represents their most significant contact with the U.S. Government. The importance of making this process run smoothly, therefore, cannot be overstated.

More than 60 percent of individual taxpayers use the services of a paid tax return practitioner to prepare and file their individual tax returns, as do most business taxpayers. It is remarkable to me that, in the United States today, an insurance agent can't sell insurance without a license, a contractor can't build without a license, and a hairstylist can't touch a lock on a person's head without a license – yet anyone can prepare a tax return for a fee – with no training, no licensing, and no oversight required. 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.⁴⁰ 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. While the IRS operates a number of programs that address the perpetration of criminal schemes by tax preparers, it conducts only a small number of preparer negligence investigations, and it collects even fewer dollars in the rare instances that it assesses a preparer negligence penalty.⁴¹

A recent study conducted by the U.S. Government Accountability Office (GAO) underscores the significant problems that exist today in the tax preparation industry. GAO auditors posing as taxpayers made 19 visits to several national tax preparation chains in a large metropolitan area. Using two carefully designed fact patterns, they sought assistance in preparing tax returns. Errors were made by the tax preparation chains in all 19 of the visits. In 17 of the 19 visits, the preparers computed the wrong refund amount, with variations of several thousand dollars. In five of 10 applicable cases, preparers failed to ask relevant probing questions, and as a result, they prepared returns claiming ineligible children for the Earned Income Tax Credit. Perhaps the most troubling finding was that preparers failed to report business income in 10 of the 19 cases. Several preparers even advised the GAO "taxpayers" that reporting certain

⁴⁰ Circular 230, 31 C.F.R. § 10.50(a).

⁴¹ 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).

business income was unnecessary because the IRS would not become aware of the income from third parties.⁴²

In my 2002 Annual Report to Congress, I proposed a plan for the IRS to register, test, and certify unenrolled federal income tax preparers. 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 to ensure a basic level of competency among paid preparers.⁴³ 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 costs of goods sold. In my 2003 annual report, I further encouraged Congress to enact a more stringent compliance and penalty regime to deter reckless disregard of the rules and/or negligence by paid preparers.

In the 108th Congress, the Senate passed my proposal to regulate unenrolled preparers as part of the Tax Administration Good Government Act. In the current Congress, the proposal has been again approved by the Senate Finance Committee – this time as part of S. 832, which has been incorporated into S.1321, The Telephone Excise Tax Repeal Act of 2005. I encourage Congress to pass this common-sense legislation.⁴⁴

Of course, strengthening standards for return preparers would directly improve reporting accuracy only in cases where taxpayers use return preparers. I believe we also should take steps to promote and improve electronic filing for taxpayers who self-prepare their returns.

F. Greater Use of E-Filing Would Produce Many Benefits, Including Improved Tax Law Accuracy.

In 1998, Congress directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007.⁴⁵ The rationale for this goal is sound – e-filing significantly benefits both taxpayers and the IRS.⁴⁶

⁴² U.S. Government Accountability Office, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T, 2 (April 4, 2006) (statement of Michael Brostek, Director, Strategic Issues, before the Committee on Finance, U.S. Senate).

⁴³ The IRS could integrate the proposed examination for unenrolled preparers with the Special Enrollment Examination (SEE), the current test developed for enrolled agents. While the enrolled agent requirements would continue to be more stringent, integrating both tests could create a career path for unenrolled preparers.

⁴⁴ S.1321, § 203, Telephone Excise Tax Repeal Act of 2005, 109th Cong. (Sept. 15, 2006).

⁴⁵ Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 2001(a)(12), 112 Stat. 685 (1998).

⁴⁶ S. Rep. No. 105-174, 39-40 (1998).

Although electronic filing benefits taxpayers in several ways, perhaps the most publicized and appreciated benefit is the quicker turnaround time for refunds. Electronically filed returns also have a lower error rate, because the process eliminates IRS transcription errors and enables the IRS to pre-screen e-filed returns to ensure that common errors are fixed before the returns are accepted.⁴⁷ Finally, the transmittal by the IRS of an electronic proof of receipt with a time and date stamp provides the taxpayer with peace of mind that the return was received and passed the initial pre-screening.

The IRS benefits from e-filing through reduced costs, because e-filed returns require no transcription and are thus cheaper to process. In fiscal year 2002, a paper return cost \$2.59 to process, while an e-filed return cost 62 cents.⁴⁸ Further, the reduction of errors on e-filed returns on the front end saves an immeasurable amount of IRS compliance resources.

Electronic filing also benefits IRS compliance and research functions. The IRS has more access to tax data associated with e-filed returns than it has for paper returns. When the IRS receives a paper return, an employee manually transcribes select data into an IRS computer system. However, not all data is captured through transcription. In contrast, the IRS has the ability to fully access all of the tax data included on e-filed returns. Access to more complete data permits the IRS to perform better research and improve return selection in compliance functions.

To date, the IRS has decided against making e-filing available to all taxpayers without charge. Instead, prior to the 2003 filing season, the IRS entered into a three-year agreement with a consortium of tax preparation software companies known collectively as the "Free File Alliance."⁴⁹

The three-year term ended last year, and in October 2005, the IRS and the Free File Alliance extended the contract for four more years with some modifications.⁵⁰ The initial agreement required the Free File companies, in the aggregate, to make free electronic preparation and filing available to at least 60 percent of all taxpayers. The new agreement prevents Free File companies, in the aggregate, from making free services

⁴⁷ *Taxpayer Alert: Choosing a Paid Preparer and the Pitfalls of Charitable Car Donation: Hearing Before the Senate Finance Committee*, 105th Cong. 2 (April 1, 2003) (statement of Pamela J. Gardiner, Acting Inspector General for Tax Administration, U.S. Department of the Treasury).

⁴⁸ IRM Exhibit 3.30, Cost Estimate Reference, Exhibit 3.30.10-39 (Rev.11-01-2003).

⁴⁹ Free On-Line Electronic Tax Filing Agreement entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2002), available at www.irs.gov/efile/article/0,,id=103626,00.html.

⁵⁰ Free On-Line Electronic Tax Filing Agreement Amendment entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2005), available at www.irs.gov/pub/irs-efile/free_file_agreement.pdf.

available to more than 70 percent of all taxpayers.⁵¹ The IRS also pledged that it would "not compete with the [Free File Alliance] in providing free, online tax return preparation and filing services to taxpayers."

From an IRS perspective, the rationale for creating the Free File program was to make e-filing more accessible to taxpayers and thereby help it to achieve the congressionally mandated goal of having 80 percent of all taxpayers filing electronically. From that standpoint, the Free File program has done little to increase the number of taxpayers who e-file. In fact, taxpayers filed approximately 3.9 million individual income tax returns through Free File in the 2006 filing season as of April 29, 2006. This amounts to approximately three percent of all individual returns and represents a decrease of more than 22 percent from the rate during the same period in 2005.⁵²

The IRS has done a superb job of raising the e-filing rate above 50 percent, but it has run into a wall among a group of taxpayers who are unwilling to file through third party service providers for either of two reasons. Some taxpayers are unwilling to pay fees to file electronically when they can mail their returns for the cost of a postage stamp. Other taxpayers are concerned about routing their personal tax and financial information through a third-party service provider.⁵³ IRS data shows that, as an evident consequence of these concerns, roughly 40 million 2004 tax returns were prepared using software yet were submitted on paper.⁵⁴ That result is bad for tax administration because it requires the IRS to pay employees to enter data into a computer manually, increases the risk of transcription errors, and delays the issuance of refunds. I believe that if the IRS were to offer a free direct filing portal, most of these returns would be transmitted electronically and that both the government and taxpayers would benefit. According to the Federation of Tax Administrators, 21 states and the District of Columbia allow taxpayers to file their returns directly without the use of third-party intermediaries.⁵⁵ I urge Congress to direct the IRS to authorize and develop this procedure as well.

Finally, the IRS discontinued the TeleFile program after the 2005 filing season due to high costs and low demand. This decision appears contrary to the express direction of Congress to continue and improve TeleFile.⁵⁶

⁵¹ *Id.* Section I.E provides in relevant part: "IRS will utilize the then current Adjusted Gross Income (AGI) number which equates to 70% of the taxpayers to manage the program, and will not accept or post any offer by an Alliance member which exceeds this AGI amount."

⁵² IRS, 2006 Filing Season Data for Week Ending 4/29/2006.

⁵³ Russell Marketing Research, *Findings from Focus Groups Among Taxpayers With Self-Simple Returns*, screen 22 (March 2003).

⁵⁴ IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

⁵⁵ *Statement of the Federation of Tax Administrators Before the Committee on Finance, U.S. Senate, Hearing on Preparing Your Taxes: How Costly Is It?* 109th Cong. (April 4, 2006).

⁵⁶ See H.R. Conf. Rep. No. 105-599 at 235 (1998).

I believe that the IRS needs to provide a better alternative for paper filers, a group that includes former Telefilers who are reluctant to switch to e-file.⁵⁷ In my 2004 annual report to Congress, I suggested that the IRS develop 2-D bar code technology to allow taxpayers to benefit from increased accuracy in capturing data while the IRS incurs lower processing costs.⁵⁸ However, the IRS continues to reject this proposal, citing cost barriers. It is my understanding that the IRS has already incorporated this technology into other functions. In addition, the IRS has indicated that it opposes 2-D bar code technology because it does not want to develop technology that the IRS does not deem to be electronic filing.⁵⁹ I find this argument unpersuasive because, although the returns are received in paper form, bar codes provide taxpayers and the IRS with many of the same benefits as electronic filing.

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:

- 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

⁵⁷ In tax year, 2001, when taxpayers stopped using TeleFile, 55 percent went back to paper and 45 percent used an electronic product. See "TeleFile Survey Report," Research Project 1-03-08-2-107N, W&I (Wage & Investment) Research Group 1, screen 43 (Nov. 2003).

⁵⁸ To utilize 2-D bar code technology, a taxpayer or preparer uses software to complete the return. Once printed, the return has a horizontal and vertical bar code containing tax return information. The IRS scans the return, captures the data, decodes it and processes the return as if it had been sent electronically.

⁵⁹ National Taxpayer Advocate 2004 Annual Report to Congress 89-106.

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	A local planning organization could work to identify local compliance challenges, direct the IRS's local response, and measure its effectiveness.	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.

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.
9	Educate cash economy participants	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.
		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
<p>1 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". 	<p>Current withholding and information-reporting provisions do not adequately capture income from transactions in the cash economy. Unreported payments include:</p> <ul style="list-style-type: none"> ▪ Deliberate "under the table" cash payments. ▪ Payments that are reported with an invalid TIN or payee/TIN mismatch. ▪ Payments subject to information reporting that are not reported. <p>Withholding is not required on payments to non-employees, and skirting information reporting requirements for payments to independent contractors is easy and relatively painless. Payors wishing to comply with their information-reporting obligations may be reporting payments to independent contractors who have supplied invalid TINs. Under existing provisions, these payors may not know that a payee's TIN is invalid until several payments have been made. Furthermore, the motivation to comply with current Forms 1099-MISC and W-9 requirements is not particularly compelling. The toll charge for a missing or incorrect Form 1099-MISC or W-9 is \$50.</p>
<p>2 Amend IRC § 6302(h) to require IRS to promote estimated tax payments through EFTPS.</p>	<p>Amend IRC § 6302(h) to require IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by FY 2012.</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. 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).
		Some independent contractors may wish to enter into withholding agreements with their payors. It is currently unclear, however, whether statutory authority exists to enter into such agreements. IRC § 3402(p)(3) is silent on voluntary withholding agreements in the independent contractor/payor context. Section 3402(p)(3) is the only section under which a voluntary withholding agreement between a payor and an independent contractor would be permitted.
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
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.	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.	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.

Testimony of Jay A. Soled
Professor of Taxation Rutgers University
Before the
Committee on Homeland Security and Governmental Affairs
September 26, 2006

CLOSING THE CAPITAL GAINS TAX GAP

Mr. Chairman and Distinguished Members of the Committee:

My name is Jay Soled. I am a professor of taxation at Rutgers University and I have written several papers on the issue of the capital gains tax gap. Thank you for inviting me to testify on how the government can close the capital gains tax gap and, in particular, in favor of the Simplification Through Additional Reporting Tax ("START") Act of 2006. This legislation, which was endorsed by the National Taxpayer Advocate, was introduced several months ago by your colleague, Senator Bayh, and co-sponsored by this Committee's Co-Chair, Senator Carper, would require mutual fund companies and brokerage firms to track and report an investment's tax basis to both taxpayers and the IRS.

Before detailing the importance of the START Act, however, I think it's incumbent upon me to highlight several salient points that were (and were not) made by the General Accountability Office ("GAO") in a report it issued earlier this year entitled the "Capital Gains Tax Gap."

- First, what the GAO report stated is that for tax year 2001, an estimated 38 percent of individual taxpayers who had securities transactions failed to accurately report their capital gains or losses from these transactions.
 - What the GAO report did not say is that if security ownership continues to expand and is left unchecked, almost four out of every ten taxpayers will submit income tax returns that are incorrect.
- Second, the GAO report stated that these mistakes cost the government over \$11 billion annually.
 - What the GAO report did not emphasize, however, is that this \$11 billion figure relates to individual income tax returns in 2001. As such, it probably grossly understates the magnitude of the problem. If the GAO were to have expanded the scope of its investigation to include corporate and other taxpayers such as trusts and estates, the estimated revenue loss to the government could easily exceed \$25 billion annually.

- Third, the GAO report stated that the IRS is virtually powerless to close the capital gains tax gap.
 - Without trying to paint too bleak of a picture, what the GAO report was really saying is that even if the IRS could audit every single taxpayer's return, the capital gains tax gap would, unfortunately, remain largely intact. This is because most taxpayers lack accurate records and the ability to track the tax basis they have in their investments.

Why is the size of the capital gains tax gap so large? Let me offer five reasons.

Reason #1: Taxpayers are notoriously lax record keepers. When it comes to record keeping, few taxpayers would deserve Oscars for their efforts. Record keeping relating to tax basis information is particularly nettlesome insofar as these records must commonly be maintained for years or even decades.

Reason #2: Computation of an investment's tax basis can be extraordinarily complex. The starting point for basis computation seems simple enough: tax basis is equal to cost. But this is where the simplicity ends. For a moment, consider that when it comes to gifts, a recipient takes a carryover basis (unless, of course, any gift tax is paid); when it comes to death, a recipient takes a basis equal to fair market value (unless, of course, the estate's executor had elected the alternative valuation date); when it comes to stock splits, a shareholder must reduce his stock tax basis in half (unless, of course, the stock split constitutes a taxable event). The bottom line is this: an asset's tax basis is fluid, and the fluidity of tax basis can sometimes overwhelm even the most civic-minded taxpayer.

Reason #3: When it comes to third-party information returns, there is no tax basis reporting to the IRS. Think otherwise? Check out the face of a Form 1099, which reports the amount realized from a transaction but not the sold asset's tax basis. Past studies universally indicate that in the absence of information returns, taxpayer compliance plummets. (In comparison, when information returns are in place, compliance usually hovers around the 99% mark.) Indeed, the Commissioner of the IRS, Mark Everson, has previously stated that compliance is highest when there is third-party information reporting. There is simply no reason to assume that when it comes to tax basis reporting, in the absence of third-party information returns, halos magically appear above taxpayers' heads.

Reason #4: The IRS has a disincentive to pursue tax basis issues. One of the fundamental myths that pervade this area of the law is that in the absence of substantiating evidence, an asset's tax basis is deemed to be zero (i.e., all sale proceeds are treated as taxable income). Instead, the truth is that the so-called Cohan rule applies. This rule allows the taxpayers to estimate an investment's tax basis. In tax controversies, the Cohan rule often gives taxpayers the upper hand against the IRS.

Reason #5: The penalty for misreporting an asset's tax basis is so negligible that it is likely to be ignored. The Code's penalty structure serves as a strong deterrent against taxpayer noncompliance in income tax reporting. However, this is not so when it comes to tax basis

misreporting: the penalty for such misreporting is ordinarily 20 percent of the tax due; multiplying this rate against the highest capital gains rate of 15 percent only produces a tiny 3 percent toll charge, with respect to tax basis misidentifications.

The START Act offers hope to taxpayers and the government that tax basis misidentifications will be a problem of the past and that the capital gains tax gap will narrow. Due to technological changes, the time to implement this legislation is now. Never before have the financial markets been this poised to institute reforms of the nature suggested.

Kindly allow me to highlight the salient features of the START Act. They are as follows:

- The Act would require that mutual fund companies and brokerage firms track the tax basis of their clients' investments.
- Upon the triggering of a reporting event (such as a sale or other disposition), the mutual fund company or brokerage firm would, in addition to reporting the amount realized, also report the investment's tax basis.
- The Act would function prospectively, effective for transactions commencing after 2007.
- The Secretary of the Treasury would be delegated the duty of drafting regulations and detailing the specifics of how this reporting requirement would be implemented.

Passage of the START Act and broader tax basis legislation to close the capital gains tax gap would be a boon to taxpayers, the government, and even mutual fund companies and brokerage firms.

The benefits to taxpayers would be as follows:

- Taxpayers would have easy access to critical tax basis information and save them tremendous amounts of time preparing their tax returns. Put slightly differently, every April 15 there would likely be far fewer shoeboxes that taxpayers would have to dust off and bring to their accountants.
- Next, in having their tax returns professionally prepared, taxpayers would not have to spend additional money to have their accountants compute the tax basis of their investments.
- Finally, receipt of these third-party information returns would instill taxpayer confidence in the integrity of the tax system and in the belief that, in general, everyone is shouldering his fair share of the nation's tax burden.

The benefits to the government would be as follows:

- The most identifiable benefit is that the government could, over a ten-year scoring period, collect up to an additional quarter of a trillion dollars of revenue.
- Furthermore, having put the brakes on tax basis misreporting, the IRS could redirect its scarce resources to other areas where taxpayer compliance is lagging.

The benefits to the mutual fund companies and brokerage firms would be as follows:

- There are a fair number of taxpayers who invest on their own without the use of a mutual fund company or brokerage firm to assist them. Implementation of the START Act legislation could attract these “independent” taxpayers to retain the expertise of the financial service industry to relieve them of the burdensome chore of tax basis identification.
- Moreover, around tax season, no longer would individuals who staff the telephones and offices at mutual fund companies and brokerage firms be beleaguered by clients who call or stop by and make tax basis inquiries.
- Mutual fund companies and brokerage firms often already provide tax reporting services for their higher net worth clients. By mandating tax basis reporting for all their clients, the financial service sector could have a universal practice.

My biggest complaint with the START Act is that it doesn’t go far enough. More comprehensive legislation is probably required to narrow the capital gains tax gap even further. Such comprehensive legislation might include the following features:

- First, third-party tax basis reporting requirements should include closely held business interests in S corporations, partnerships, and limited liabilities. Currently, the face of a Form K-1 (which is issued annually to the owners in these closely held business enterprises) suffers from the same deficiency as the face of a Form 1099-B: neither contains critical tax basis information.
- Second, taxpayer obligations to properly identify the tax basis they have in their investments should be strengthened. Just as the Internal Revenue Code requires substantiation of travel and entertainment expenses, taxpayers should be required to substantiate, rather than estimate, the tax basis they have in their investments.
- Third, legal changes should be instituted that simplify tax basis identifications. These changes might include several minor tweaks such as eliminating Code § 1015(d)(6), which upwardly adjusts the tax basis of gifted assets by a portion of the gift tax paid on the receipt of appreciated property. Other changes might include more fundamental reforms, such as moving to a mark-to-market tax system that requires annual recognition of all gains and losses.

So, from my perspective, the START Act is just that—a starting point that should immediately be put into place. With its passage, however, Senators, please do not consider your work done. Knowledge of an asset's basis is fundamental to our income tax system where gains and losses are computed upon the difference between the amount realized and an asset's tax basis. Proper tax basis identification is thus the key to the continued success of the income tax. Therefore, any compliance mechanisms that you can put into place should be gladly welcomed by taxpayers and politicians alike who care about our nation's fiscal solvency and the integrity and equity of the Internal Revenue Code.

In closing, Senators, before you ask me any questions, please let me take this opportunity to pose a question to each of you: Do you know the tax basis you have in each of your investments? Assuming you don't, then you should recognize the importance of the START Act and the need for its immediate passage.

**INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION
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**Statement of Stephen J. Entin
President and Executive Director
Institute for Research on the Economics of Taxation**

before the

**Senate Committee on Homeland Security and Governmental Affairs
Subcommittee on Federal Financial Management, Government
Information, and International Security**

**Deconstructing the Tax Code:
Uncollected Taxes and Issues of Transparency
September 26, 2006**

Mr. Chairman and Members of the Subcommittee, thank you for inviting me to discuss the concept of a tax expenditure data base and its relationship to the issue of tax transparency.

I would like first to address the issue: "What is tax transparency?" Tax transparency is an attribute of the tax system. It does not mean exposing taxpayers' incomes, business dealings, and tax liabilities to public scrutiny by publishing everyone's tax return.

Transparency means adopting a tax system based on sensible principles that are widely understood and agreed upon; that results in a measure of taxable income that corresponds to the real incomes of the taxpayers; and that permits simple, straightforward calculations of tax liabilities that are crystal clear to taxpayers and tax enforcers. A transparent tax system would be simple, would measure income correctly, and would treat all income and all taxpayers alike. It would put to rest suspicions that some people were not paying what they owed, and end the envy that one taxpayer feels when he is not eligible for a tax provision that benefits his neighbor.

Each taxpayer would have to apply that set of tax rules to his or her income, and pay the resulting tax liability. The tax returns and tax payments, however, would not be public. The tax law and tax rules would be transparent and manifest to everyone, not the incomes, business arrangements, and tax payments of the taxpayers.

Federal tax law, Section 6103 of the U.S. Code, requires that the IRS protect taxpayer privacy, and the IRS has very strict policies to enforce that legal mandate. The Statistics of Income division of the IRS compiles considerable data on incomes, filing status, and the use of various provisions in the tax code. The raw information, that is, the actual "tax file", is available only to employees of the IRS and the Treasury's Office of Tax Policy, and to employees of the Joint Tax Committee.

Tax file data is authorized by law to be shared with a limited number of other Federal agencies in a protected manner. Such data is shared only in a form that has been carefully "scrubbed" (organized in large enough subgroups or income classes) to protect the identity of the taxpayers. (See the chapter by Nick Greenia and Mark Mazur, "IRS Data, Data Users, and Data Sharing", in *Improving Business Statistics Through Interagency Data Sharing*, National Research Council of the National Academies, National Academy Press, Washington, D.C., 2006.)

Data reported in the "public use file" on the individual income tax that is made available to private sector researchers is even more carefully organized. This is done so that researchers cannot work back from the data to determine the incomes and tax filings of any individual. There is no comparable "public use file" for corporations, the data for which are reported with even fewer identifying characteristics. The far smaller number of businesses, and the availability of other public information they are required to release, would make it too easy to use disaggregated IRS data to determine information on a single taxpayer.

Would a tax expenditure data base improve tax transparency? No. Estimates of tax expenditures are already published by the Treasury, the Joint Committee on Taxation, and the Ways and Means Committee in print and on the web. The Treasury tables are also presented in the Analytical Perspectives volume of the Budget of the United States Government. These sources list tax expenditure provisions and estimate the aggregate number of users (individuals and corporations) and the dollars involved.

Could a tax expenditure data base by individual or by business be constructed? Going into more detail on tax expenditures would be expensive and difficult. It is one thing to use a sample of tax returns to estimate the use of tax provisions considered to be tax expenditures. It is

quite another to examine every return and identify and publish which specific taxpayers use them and the dollar amounts saved by each filer. Such an effort would involve considerable cost for the IRS.

Furthermore, a more detailed presentation would run into serious privacy concerns. The law pertaining to taxpayer privacy, Section 6103 of the U.S. Code, would have to be revisited. Pursuant to that section, the IRS does not reveal tax information that could be traced back to an identifiable taxpayer. For example, the IRS will not release figures in any cell or class of taxpayer on deductions, exclusions, or credits unless there are at least three beneficiaries nationally or ten within a state.

The IRS relies on a high level of voluntary compliance by taxpayers to enable it to enforce and administer the tax system. A high level of compliance depends to a considerable degree on taxpayers' trust that their tax returns will remain confidential. There would be considerable and very justified resistance to removing the privacy protections by taxpayers and tax administrators.

Many provisions listed as tax expenditures involve the calculation of a deduction from taxable income, or a credit against tax. A taxpayer's worksheets are not reported on the tax returns, only the resulting adjustment to income or tax. Tracking the specific provision and amount by taxpayer would involve greatly expanded reporting requirements for individuals and businesses.

The aim of a data base would be to highlight tax provisions that are clearly unwarranted favoritism toward a small group of taxpayers. Under House and Senate rules, such "rifle shot" tax breaks are currently supposed to be identified before the bills are voted upon. Once enacted, it is difficult for the IRS to determine which taxpayers are using the provisions, unless they show up in an audit. It is really the responsibility of the Congress to avoid crafting such provisions in the first place.

A more basic question is "What is a tax expenditure?" A tax expenditure is defined in the law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." They achieve objectives that might otherwise have been handled by government spending or regulation.

That may look simple, but tax expenditures are harder to deal with in practice than the definition might suggest. I have offered as a written submission IRET Policy Bulletin 84, *The*

End of Tax Expenditures As We Know Them?, by Bruce Bartlett, which we published in 2001. It discusses the history of tax expenditures, the difficulty in measuring them, and the conceptual problems of determining what is and what is not a tax expenditure when there is widespread disagreement on the nature of the ideal tax system. I have also made available to the Subcommittee copies of IRET Fiscal Issue 6, *Tax Expenditures: A Critical Appraisal*, which favors using a saving-consumption neutral tax as the baseline (a.k.a. consumed-income, or consumption-based tax).

The concept of what is a tax expenditure varies with one's view of the ideal tax system. What constitutes "special" treatment, and what is or is not a tax expenditure, depends critically on what is regarded as regular treatment under the tax system. The Analytical Perspectives report tax expenditures under two income tax baselines. Since the Fiscal Year 2004 Budget, it has also provided a very different list of tax expenditures as measured against a neutral or consumed-income tax concept.

Let me give some examples. In the pure "Haig-Simons" income tax, there would be no double taxation of corporate income, which would be attributed to the shareholders. Anything now listed as a corporate-related tax expenditure would disappear under that definition, and the corporate tax itself would become a "negative" tax expenditure. Capital gains and the imputed income from owner-occupied housing would be taxed as accrued. Deferral of the tax on capital gains would be considered a tax expenditure. However, inflationary gains and the inflation element of interest would be excluded from interest income and from interest deductions, and depreciation would be inflation-adjusted. Failure to adjust for inflation, as in the current tax system, would result in "negative" tax expenditures on the inflation component of capital gains, interest income, and depreciation, and a tax subsidy on interest deductions.

The income tax we have today deviates from the original Haig-Simons precepts. The Treasury reports tax expenditures under the "normal tax baseline" and the "reference tax law baseline". Each accepts the corporate income tax and the deferral of taxes on unrealized capital gains as normal, and not, respectively, as either a negative or a positive tax expenditure. The reduced tax rates on dividends and capital gains offset some of the double taxation of corporate income, and are part of the move toward a more neutral consumption-based system; they are not considered tax expenditures by the Treasury.

The normal baseline brands more provisions as tax expenditures, because the reference tax law accepts as a natural starting point some of the features of the tax law that deviate from the purer version of the income tax. The normal baseline counts the lower tax rates applied to married versus single filers as tax expenditures, while the reference baseline does not. The

normal baseline counts the lower than maximum corporate tax rates as a tax expenditure, while the reference baseline does not. The normal baseline regards accelerated depreciation beyond "economic depreciation" as a tax expenditure, but the reference baseline does not. Exemption of government cash transfer payments is a tax expenditure under the normal baseline, but not under the reference baseline.

The personal exemption and the standard deduction are considered normal in both methods, and are not listed as tax expenditures. The exclusion of income from owner-occupied housing is not considered a tax expenditure, but, as a consequence, the deduction of mortgage interest is. The exclusion of health care premiums on employer-provided insurance is considered a tax expenditure. The arbitrary nature of these assumptions is obvious. The Joint Tax Committee classifies a few items differently from the Treasury.

The differences are even greater when compared to a consumption-based tax. Pension arrangements and IRAs are considered tax expenditures under the income tax baselines. Under a consumed-income or saving-consumption neutral tax, all saving would normally receive pension or IRA treatment. In that system, the extra tax on ordinary saving under the income tax would be regarded as excess taxation, and would be branded a "negative" tax expenditure.

Treasury reports other differences under a consumption-based concept. In my view, it is a much superior table, but not perfect. Treasury regards state and local government services as consumption, and calls the deduction of state and local taxes a tax expenditure. Yet most state and local outlays are either investment in human capital (education) leading to higher taxable income for individuals, or transfer payments to persons who should be subject to tax. These ought to be deductible by the taxpayers.

These examples only scratch the surface of the differences one finds as concepts of the ideal tax system vary. Another issue relates to measurement. As the Special Analyses chapter points out, any change in the tax law regarding the tax expenditure provisions would lead to substantial changes in taxpayer behavior. In addition, the presence of many tax expenditure provisions means that the revenue associated with any one of them is affected by the existence of the others. The numbers also vary whenever the level of the basic tax rates is altered. The present value of a tax expenditure, considering its pattern over time, may be very different from the current year figure. All the numbers associated with these provisions must be taken with a grain of salt.

In conclusion:

Tax expenditures are generally fairly broadly available. They are not typically the "rifle shot" special interest benefits that would be comparable to earmarks on the spending side of the budget. (I offer no support to the rifle shot provisions.)

Tax expenditures are often deliberate and well-crafted offsets to the relatively heavy tax burden imposed by the income tax on income from capital. They are partial steps toward a consumption base. There is nothing wrong with moving in that direction. In fact, the income base is so detrimental to capital formation, productivity, and wages that many economists regard the neutral tax base alternatives as clearly superior.

Some tax expenditures are bad tax policy, but listing all tax expenditures by beneficiary, even if it were possible to do so, would offer no guidance as to which ones ought to be repealed.

Tax expenditure provisions are part of the tax code. Using them is not tax evasion. The provisions are not part of the "tax gap" from non-compliance.

A tax expenditure data base akin to the earmark and grant data base is not a sound concept, nor a workable idea.

**THE END OF TAX EXPENDITURES
AS WE KNOW THEM?****Introduction**

In its 2002 budget, the Bush Administration launched a stealth attack on the concept of "tax expenditures." The Reagan Administration made a similar effort in 1982, only to backtrack in the face of criticism and continue with the status quo henceforth. Although the Bush effort has come in for criticism as well, observers believe that it is much more likely to stick to its guns. A key reason is that in the years since the Reagan initiative, various aspects of tax expenditures have been heavily critiqued by tax theorists, both economists and legal scholars. If the Bush Administration stands up to the critics and presses forward with its attack on the way tax expenditures have been calculated and used, it could have a very profound, long-term effect on future tax policy in the United States.

Origin of Tax Expenditures

Ever since the beginning of the federal income tax in 1913, there have been deductions and exclusions that caused taxable income to be less than gross income. For example, the very first income tax return allowed deductions for all interest paid, state and local taxes paid, and depreciation.

Economists have always been interested in these deductions and exclusions because of their impact on the distribution of the tax burden, their incentive effects and their impact on overall revenue.¹ However, until the 1960s there was no comprehensive catalogue of tax preferences, nor a standard method for analyzing them.

This situation began to change when Stanley Surrey, a professor of law at Harvard University, became assistant secretary of the Treasury for tax policy during the Kennedy Administration. Surrey believed strongly that many provisions of the Tax Code had economic effects identical to government spending. However, as part of the Tax Code, they came under much less scrutiny than did spending programs. Surrey sought to create a method whereby tax provisions and spending programs could be reviewed simultaneously by Congress in order to improve the policymaking process.²

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Under Surrey's leadership, the Treasury Department began to catalogue tax preferences and develop a methodology for measuring them. By the closing days of the Johnson Administration the Treasury had completed its preliminary work on the subject of what Surrey now called tax expenditures.³ Surrey clearly intended the term "tax expenditure" to be pejorative, undermining political support for tax preferences. Treasury Secretary Joseph Barr presented the results at a hearing of the Joint Economic Committee a few days before President Nixon's inauguration. The hearing is best remembered for Barr's disclosure that 21 people earned more than \$1 million in 1967 without paying any federal income tax, due to their utilization of tax preferences.⁴

Almost immediately, there were efforts in Congress to require the Treasury Department to publish a tax expenditure budget annually. These efforts were resisted by the Nixon Administration. However, the Congressional Budget and Impoundment Control Act of 1974 forced the President to report annually on tax expenditures in his budget. It also required a tax expenditure estimate to be made for all bills reported by congressional committees.⁵

Conceptual, Accounting, and Measurement Problems

Because tax expenditures went from being a concept to becoming part of the law so quickly, basic conceptual problems of selection and measurement were glossed over. In the Budget Act, tax expenditures were defined as follows:

The term "tax expenditure" means those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability; and the term "tax expenditures budget" means an enumeration of such tax expenditures.⁶

Professor Boris Bittker of Yale University was one of the first to call attention to the problems inherent in identifying and measuring tax expenditures. First, he said, there is no general agreement on what constitutes an ideal or correct tax structure to begin with, against which to determine deviations that can be considered tax expenditures. Second, there are problems in defining the taxpaying entity, the appropriate taxable period, and a set of accounting principles. And third, there is a problem of measurement.⁷ The first problem is most important. As Bittker put it:

A systematic compilation of revenue losses requires an agreed starting point, departures from which can be identified. What is needed is not an ad hoc list of tax provisions, but a generally acceptable model, or set of principles, enabling us to decide with reasonable assurance which income tax provisions are departures from the model, whose costs are to be reported as "tax expenditures"....The lack of an agreed conceptual model makes it impossible to say whether a large number of structural features of the existing federal income tax laws are, or are not, "tax expenditures"....The proposal is feasible

only to the extent that we can agree on a conceptual model, for a "tax expenditure" is nothing more than an estimate of the amount of revenue that would be raised if the law conformed to such an agreed model.

As to the second point, there are important conceptual and measurement problems related to whether the taxpaying entity is the individual or the family and how corporations should be treated, among other things. There is also a question of the appropriate accounting period. A year, after all, is somewhat arbitrary, and one could argue that tax burdens ought to be calculated over a lifetime.⁸ However, choosing between the two makes a great deal of difference in calculating tax expenditures.

Lastly, the issue of measuring tax expenditures is complicated by their effects on behavior. One cannot simply recompute an individual's tax liability with and without the tax expenditure, Bittker argued, because we cannot know what the taxpayer would have done in its absence. If a tax provision caused a taxpayer's behavior to change, then eliminating the provision may only cause him to change back again. This makes any measurement of how much revenue the government would gain from repealing a tax provision almost impossible to calculate accurately. It also means that we cannot know the distributional consequences of many tax provisions, even though distributional considerations now dominate the tax policymaking process.⁹

Haig-Simons

As Bittker noted, it is essential to have some point of reference or baseline against which to determine what is and what is not a tax expenditure. Since World War II, economists and lawyers have tended to rely upon the definition of income developed by Professors Robert M. Haig and Henry C. Simons in the 1920s and 1930s to determine what does and what does not belong in the tax base.¹⁰ Simons' definition is the one most widely quoted:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.¹¹

Thus for tax purposes, income consists of consumption plus the change in the value of one's net wealth between December 31 of one year and December 31 of the next. While this may appear to be straightforward, there are innumerable problems in applying such a definition to specific tax situations. As Bittker put it:

The trouble is that, aside from the many ambiguities that become apparent as soon as one attempts to apply the Haig-Simons definition to the protean stream of economic life, any system of income taxation is an aggregation of decisions about a host of structural issues that the Haig-Simons definition does not even purport to settle.¹²

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Surrey implicitly admitted that a pure Haig-Simons definition of income could not serve as the ideal.¹³ While acknowledging that the tax expenditure concept was based on Haig-Simons, Surrey amended it to exclude the imputed income on owner-occupied housing, the personal exemption, differential tax rate schedules and income-splitting for married couples—all deviations from a pure Haig-Simons tax base. He argued that what tax expenditures were really designed to show is deviation from some generally accepted normal tax base, not the variations from a theoretically unattainable ideal.¹⁴

Bittker replied that no consensus existed as to what a normal tax base should be. Therefore, having abandoned the purity of Haig-Simons, Surrey is adrift in a sea of value judgements and his is no better than any other expert's. Thus it is presumptuous for him to label his definition (i.e., the Treasury's) as the one correct definition, any deviations from which will be labeled tax expenditures.¹⁵ A more recent critique makes the same point as follows:

While the several existing tax expenditure budgets give an appearance of being the products of a highly sophisticated, expert, neutral examination of the tax system, they could just as accurately be characterized as exercises in mystification. They create an illusion of value-free scientific precision in a heavily politicized domain.¹⁶

As Surrey himself noted, a strict application of the Haig-Simons definition would require that individuals be taxed on the imputed income they derive from living in their own homes.¹⁷ For instance, if two people each lived in the identical house and each owned the other's home, they would pay rent to each other, which would be taxable. But if they simply lived in their own home they would not pay rent to themselves and thus no taxable income would arise. Yet, in principle, the income is still there even though it is untaxed. Consequently, the Department of Commerce includes such income in its calculation of gross domestic product. In 1999, it amounted to \$576.4 billion.¹⁸ However, the nontaxation of imputed rent on owner-occupied homes does not appear on the list of tax expenditures.¹⁹

It has also been suggested that a pure Haig-Simons definition of income would require people to be taxed on the imputed income they derive from public capital, such as roads.²⁰ It has been argued that married couples, where only one spouse works outside the home, be taxed on the household production of the nonworking spouse.²¹ Similarly, since leisure has economic value, it too should be taxed.²² And it has been suggested that Haig-Simons requires the taxation of human capital, such as education, since human capital is as much a form of wealth as anything else.²³

Furthermore, experts have questioned the exclusion of marginal tax rates below the top rate from the tax expenditure list. After all, the lower rates for corporations are treated as tax expenditures currently.²⁴ They have also questioned the exclusion of the personal exemption and standard deduction as well.²⁵

On the other hand, experts have argued that such things as the deductions for charitable contributions,²⁶ medical expenses,²⁷ qualified pension plans,²⁸ casualty and theft losses,²⁹ state and local taxes,³⁰ mortgage interest,³¹ and accelerated depreciation,³² as well as the exclusions for scholarships,³³ foreign earned income,³⁴ and inside buildup on life insurance policies,³⁵ the deferral of taxes on foreign-source income,³⁶ and other items currently listed as tax expenditures are in fact part of the normal tax structure and ought not to be considered as tax expenditures.³⁷

Similarly, it has been argued that such things as personal interest expenses, which are not now deductible, ought to be deductible under an appropriate definition of income.³⁸ It has been argued that there should be a full offset for net operating losses by businesses.³⁹ And a number of supporters of the Haig-Simons concept, including Simons himself, have argued that there should be no corporate income tax under Haig-Simons.⁴⁰ This obviously raises an important question as to whether there can be any such thing as a corporate tax expenditure.

A strong case can even be made that lower rates on capital gains are not a tax expenditure because there should be no taxation of capital gains.⁴¹ In fact, it has been argued that if one defines income in present-value terms, there would be no taxation of capital at all even under a Haig-Simons definition of income.⁴² At a minimum, capital gains should be fully adjusted for inflation, a position endorsed by Haig, Simons and virtually all tax experts.⁴³

Indeed, so great is the confusion over what is and is not a tax expenditure that the Treasury Department and the Joint Committee on Taxation do not even agree on the issue. The appendix lists those items considered to be tax expenditures by the JCT but not by the Treasury and vice versa. It is also worth noting that different countries place different items on their tax expenditure lists, even when they generally agree on the same basic principles for analysis.⁴⁴

In addition, compilers of tax expenditures sometimes change their minds. For example, in the fiscal year 1983 budget, Treasury dropped a number of items from its previously published list of tax expenditures, on the grounds that they were really part of the basic tax structure rather than deviations from it.⁴⁵

This is not to say that each of these often contradictory positions is necessarily correct. The point simply is to demonstrate that there is no consensus and many sharp disagreements about fundamental issues on the question of what is and is not a tax expenditure.

Measurement of Tax Expenditures

This discussion of saving also highlights another important problem with the tax expenditures concept, which is how they should be measured. Historically, tax expenditures have been measured on a static revenue-loss basis. That is, taxpayers' liabilities are calculated with

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and without the tax expenditure and no change in behavior is assumed. Also, each tax expenditure is calculated separately.

Critics of this methodology have raised a number of important problems with it. Perhaps the most important is that calculating tax expenditures in this way does not make them comparable to budget outlays, which was the whole purpose of creating the tax expenditure budget in the first place. As former Treasury Department economist Seymour Fiekowsky explains:

First, tax expenditure budgets have not been constructed with consistent reference to a budgetary format that distinguishes tax provisions that function to execute an expenditure program objective from those provisions that bear on questions about the efficiency and equity of the basic tax structure. Second, the estimated magnitudes of tax expenditures are generally neither dimensionally comparable to amounts conventionally entered on the uses side of the budget, nor are they computed in a manner which makes them additive with each other.⁴⁶

In other words, tax expenditures do not measure how much money the government would have to spend to induce the same behavior or put taxpayers in the same position they would be in without the tax expenditure. And because each tax expenditure is calculated without reference to the rest of the tax expenditure budget, they cannot be added together to give a meaningful budgetary presentation. Moreover, many tax expenditures are fungible. For example, a taxpayer denied the use of a 401(k) pension plan might be able to take advantage of a Keogh plan, an Individual Retirement Account, or an annuity to achieve the same tax saving.

The additive problem is also complicated by the fact that revenue losses are calculated against a given statutory rate structure. This means that the higher marginal tax rates are, the greater the revenue loss attributed to a tax expenditure. This is because a \$1 deduction or exclusion is worth 40 cents to someone in the top tax bracket, but only 15 cents to someone in the lowest bracket. If the average marginal tax rate rises, then the dollar value of the entire tax expenditure budget will rise even if there is no change in tax expenditures per se. Conversely, of course, reductions in marginal tax rates will shrink the size of the tax expenditure budget. Thus the rate reductions in the Tax Reform Act of 1986 reduced the aggregate size of the tax expenditure budget by an estimated \$115 billion.⁴⁷

Beginning in 1982 the Treasury improved its presentation of tax expenditures by calculating them on both a revenue-loss and outlay-equivalent method. This gives policymakers a clearer picture of what the government would have to spend in order to accomplish the same purpose for which the tax expenditure was created. Thus they are more equivalent to the other numbers in the budget. In general, the outlay-equivalent numbers are higher than the revenue-loss figures, because outlays would be taxable, thereby requiring higher spending to achieve the same goal.

Another measurement problem is related to the way specific tax expenditures are calculated. For example, in the case of tax-exempt interest on municipal bonds, the tax expenditure is simply calculated as if the interest were taxable. However, this ignores the fact that interest rates on municipal bonds are lower than those on equivalent taxable securities precisely because they are tax-free. In 2000, the average interest rates on high-grade corporate and municipal bonds were 7.62% and 5.77%, respectively. Thus buyers of municipal bonds are paying an implicit tax rate of about 24%, in the form of a lower return, that is not measured in the tax expenditure budget. Obviously, if municipal bonds were made taxable their yields would rise by this amount. If one made this assumption, the revenue lost due to municipal bonds would shrink dramatically.⁴⁸

Lastly, there is the question of the appropriate accounting period in calculating tax expenditures and whether they should be calculated on a cash or an accrual basis. For example, according to Haig-Simons, capital gains should be taxed as accrued, rather than when realized. However, neither the Treasury nor the Joint Committee on Taxation lists the deferral of taxation on accrued gains as a tax expenditure. Only the revenue loss attributable to lower rates on realized capital gains is calculated.

In other cases, however, the deferral of taxation is treated as a tax expenditure. Moreover, the methodology used makes the items appear far larger than they really are. This is because not only will the government eventually receive a tax payment, but in many cases the payment will be larger than would be the case without deferral. Looking at the revenue loss over a longer time period, therefore, would greatly reduce and perhaps even eliminate any revenue loss.⁴⁹

Recently, the Treasury began calculating some tax expenditures in present value terms in order to eliminate the distortion caused by treating deferrals as if they were permanent tax exemptions. The impact is dramatic. In the case of IRAs, for example, the Treasury calculates a 2000 revenue loss of \$15.2 billion. However, because taxes will eventually be paid on IRA withdrawals and earnings, the revenue loss in present value terms is just \$5.9 billion.⁵⁰

Assessment

The tax expenditures concept is deeply flawed. The most fundamental problem is the implicit assumption that there is some ideal tax system against which to judge tax preferences. The result is that the decision to include or not include a particular item is totally arbitrary. As a recent OECD report put it, "the concept of tax expenditures is subjective and ambiguous in principle as well as in practice."⁵¹

Although it is often implied that everyone would be better off under a comprehensive income tax that excluded all tax expenditures, it is seldom stated explicitly how this would be the case. And estimates of the economic cost of tax preferences tend to be low.⁵² Rather, advocates of the tax expenditure concept prefer to argue their case as a matter of principle. Yet a closer examination of their arguments suggests that egalitarianism, rather than good tax policy,

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is the true motive. As Henry Simons admitted, "The tax system should be used systematically to correct excessive economic inequality and to preclude inordinate, enduring differences among families or economic strata in wealth, power, and opportunities."⁵³ His definition of income was clearly devised to further this goal.

Although it is often assumed that tax expenditures primarily benefit the wealthy, this is not true. The largest tax expenditures, such as for mortgage interest, primarily benefit the middle class. On balance, tax expenditures are proportional to income and tax liability.⁵⁴

It has often been argued that the very concept of tax expenditures implies that any income that is not taxed due to a tax preference belongs to the government. As the late Aaron Wildavsky put it, "In the mythology of tax expenditures, only politicians prevent experts from taxing everything."⁵⁵ For example, in the opinion of some of the tax specialists cited earlier, a case can be made for taxing, among other things, the imputed value of owner-occupied housing, the imputed income people derive from roads and other public capital, the imputed income from the household production of nonworking spouses, the value of education and other human capital, unrealized paper gains on stock and other property, and the value of leisure. In an unusual case of candor, one tax expenditure budget even admitted this fact:

The term "tax expenditures" is...unfortunate in that it seems to imply that Government has control over all resources. If revenues which are not collected due to "special" tax provisions represent Government "expenditures," why not consider all tax rates below 100% "special," in which case all resources are effectively Government-controlled?⁵⁶

More recently, Charles Fried, a prominent Harvard Law School professor, restated the point. "Lurking behind the concept of tax expenditures is a more sinister premise," he said. "It is the subtle disposition to think of all income as virtual state property, and forbearance to tax away every last penny of it as itself a tax expenditure."⁵⁷

Although the supporters of tax expenditures like to say that the concept is value-free, it is significant that tax expenditures are only calculated for tax provisions that lose revenue. A consistent application of the concept would also list tax provisions that raise government revenue above what would be the case under the reference case. As noted earlier, Henry Simons believed that the entire corporate income tax is a deviation from his definition of income. A consistent application of the Haig-Simons concept, therefore, would list the corporate income tax as a negative tax expenditure or tax surcharge. A recent survey of tax practitioners found support for including many other tax provisions this way as well. Among those mentioned are the alternative minimum tax, marginal tax rates above the average rate, the phase-out of personal exemptions and the standard deduction for high income taxpayers, and limitations on capital losses.⁵⁸

One must also ask, What is wrong with tax expenditures anyway? If they accomplish some useful purpose, why shouldn't policymakers make use of them? It may well be that using the

Tax Code, rather than the government's spending or regulatory power, is a better way to achieve some legitimate government purpose.⁵⁹ In Sweden, for example, it has been argued that tax expenditures have been very successful in promoting economic growth.⁶⁰

Whether tax expenditures are ultimately worthy of repeal depends on one's perspective. There is certainly no general case to be made for wiping the slate clean.

The Future

Were the tax expenditures budget nothing but an analytical tool, it might be unobjectionable, despite its shortcomings. But it is far more than that. It institutionalizes, in a very powerful way, a particular view of tax policy that makes it exceedingly difficult to make positive reforms.

The late Norman B. Ture once told me that almost everything bad in the Tax Code is there because of Haig-Simons. It took me a while to realize that he was right. In particular, Haig-Simons sanctions the excessively heavy taxation of capital in the United States that is both unfair and a severe constraint on economic growth. Although, to be fair, adoption of a pure Haig-Simons definition of income would improve the Tax Code in some ways. For example, the corporate income tax would disappear. But the advocates of Haig-Simons seldom advocate abolition of the corporate income tax. They are far more likely to complain about the failure to fully tax capital gains, accelerated depreciation and other tax provisions that benefit capital.⁶¹

Over the last 25 years, however, a different view has emerged among many, if not most, tax theorists that a consumption base makes a lot more sense.⁶² As the late Joseph A. Pechman noted, in his presidential address to the American Economic Association in 1989: "Today, it is fair to say that many, if not most, economists favor the expenditure tax or a flat rate income tax."⁶³ Of course, most versions of the flat tax are pure consumption-based taxes, because all saving and investment are tax deferred (i.e., expensed) or, equivalently, their returns are nontaxable.⁶⁴

When Ture became Under Secretary of the Treasury for Tax and Economic Affairs in 1981, he made an effort to change the Reagan Administration's treatment of tax expenditures. Ture believed strongly that Haig-Simons was the wrong implicit base against which to determine what is and isn't a tax expenditure. He believed that tax neutrality was the appropriate guideline, and that such a criteria essentially led to a consumption base.

In November, 1981, Mr. Ture was asked to explain his views at a hearing of the Senate Budget Committee. As was customary, the testimony was reviewed by the Office of Management and Budget, which determines whether all testimony by administration officials is in conformity with administration policy. OMB refused to clear the testimony and the hearing was canceled. Subsequently, however, the undelivered testimony was published in *Tax Notes*.⁶⁵

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First, Ture said, "the concept of tax expenditures is too vague to permit a precise definition." Second, "in contrast to outlays estimates, formidable problems are encountered in attempts to measure tax expenditures." If the attempt is nevertheless made to estimate tax expenditures, Ture argued that the benchmark against which deviations are measured should at least be coherent and principled. He recommended using a tax neutrality criterion. The items on the tax expenditure list would then show positive and negative tax subsidies relative to a neutral tax. Several years after leaving Treasury, Ture explained his alternative formulation this way:

A neutral tax system is one that would not alter the relative prices and costs of goods, services, and activities that would prevail in an efficiently functioning private market, i.e., a market the results of which are not influenced by government actions or policies. The neutrality criterion calls for a tax that changes in the same proportion the costs and prices of all alternatives confronting taxpayers... A neutral tax system would include no provisions that provide subsidies nor would it contain any provisions that differentially raise the price or cost of any product, service, or activity....

It should raise the cost of saving in the same proportion as it raises the cost of consuming, and it should raise the cost of each form of saving and of each type of consumption in the same proportion. It should raise the cost of any particular kind of job to the same degree that it raises the cost of doing any other kind of work. It should raise the cost of using capital inputs in the same proportion as it increases the cost of using labor services in production processes, and it should increase the cost of any kind of capital use to the same degree as that of any other capital use.⁶⁶

In his suppressed testimony, Ture pointed out that his alternative formulation of a neutral tax base against which to measure tax expenditures would produce important changes in the tax expenditures listing. Notably, many tax provisions that are biased against saving would appear as negative tax subsidies, that is, as special tax penalties:

Application of the neutrality criterion dictates that the entire corporation income tax should be seen as a *negative* tax expenditure—as an *incremental* levy on the net returns to capital used by corporations compared with a tax on the net returns on capital used by businesses organized in some other form. More fundamentally, we must perceive the fact that the personal income tax levied on the amount of current income which is saved and also on the returns realized on saving... [is] a *negative* tax expenditure, and any tax provision which abates the tax on current saving should be seen as a reduction in a *negative* subsidy. In the same context, the neutrality criterion dictates that *any* tax on capital gains is a *negative* tax expenditure, and any reduction in that tax is to be seen as a reduction in an extraordinary tax penalty on saving.⁶⁷

Some of Ture's ideas made it into the text of the tax expenditures presentation for the Reagan Administration's fiscal 1983 budget.⁶⁸ This presentation came under heavy attack from supporters of the traditional approach to tax expenditures, Stanley Surrey in particular.⁶⁹ Afterwards, the budget reverted to the earlier presentation and all official criticism of tax expenditures disappeared from it.

Now the Bush Administration returns to the fray. In its 2002 budget, it reiterates much of the criticism of tax expenditures from the 1983 budget. It refers to them as "so-called tax expenditures," makes reference to the concept of "negative tax expenditures (i.e., a tax penalty)," and says "the Administration intends to reconsider this presentation in the future."

The 2002 budget goes on to say that the traditional method of calculating tax expenditures "assumes an arbitrary tax base is available to the Government in its entirety as a resource to be spent." For this reason, "the Administration believes that the concept of 'tax expenditure' is of questionable analytic value."

Recognizing this threat to liberal dominance of the tax reform debate, the Bush Administration tax expenditures presentation has been attacked, just as the earlier Reagan effort was. Joel Friedman of the liberal Center on Budget and Policy Priorities said, "They're extremely off the mark." The tax expenditures list is "extremely useful and highly analytical," he added.⁷⁰

Economist Martin Sullivan suggested that the Bush Administration may be building a foundation for using consumption, rather than Haig-Simons, as the reference tax base for calculating tax expenditures in the future. This would have vast implications for what is and is not a tax expenditure. As he writes:

If the tax expenditures budget used consumption taxation instead of income taxation as its norm, all incentives for capital formation—from accelerated depreciation to capital gains relief to IRAs—would not be scored as tax expenditures...If taxes on capital, on estates, and on foreign income were removed from the normal tax system used as a baseline for scoring tax expenditures, the tax expenditures budget would be transformed from a political liability to a positive force for the types of change Republicans seek. Not only would relief from taxes on capital, on estates, and on foreign income no longer be brandished as tax expenditures, but any remaining taxes on capital, estates, or foreign income could be deemed tax penalties or negative tax expenditures.⁷¹

In conclusion, the Bush Administration's move to downgrade and revise the tax expenditures budget will help to lay the groundwork for fundamental tax reform. This is widely viewed as the administration's next major tax initiative.⁷²

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It is too soon to say if the Bush Administration will move in the direction of a consumption-based tax system. But it is clear that if it did want to move in such a direction, then it would be very helpful to establish that a Haig-Simons income base is not the only "ideal" one that can be justified. Since Haig-Simons underpins tax expenditures analysis, it reinforces the supposed superiority of an income base and is a barrier to adoption of a consumption-based system. Therefore, showing the flawed intellectual underpinning of tax expenditures is desirable to overthrowing income as the basis of taxation and establishing consumption in its place.

So far, the administration is not backing down from its criticism of tax expenditures. If it stands firm, it will greatly improve the odds that it will in fact push for a major tax reform in the near future that will shift taxation away from saving and investment. Establishing that reduced taxes on capital is not a tax expenditure is the first step.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.

APPENDIX

JCT Tax Expenditures Not on the Treasury ListNatural resources and environment

- Exclusion of contributions in aid of construction for water and sewer utilities
- Special rules for mining reclamation reserves
- Special tax rate for nuclear decommissioning reserve funds

Agriculture

- Exclusion of cost-sharing payments
- Cash accounting for agriculture
- Five-year carryback period for net operating losses attributable to farming

Insurance companies

- Special treatment of life insurance company reserves
- Deduction of unpaid property loss reserves of property and casualty companies

Business and commerce

- Expensing of magazine circulation expenditures
- Special rules for magazine, paperback book, and record returns
- Completed contract rules
- Cash accounting, other than agriculture
- Deferral of gain on in-kind exchanges
- Exception from net operating loss limitations for corporations in bankruptcy
- Tax credit for employer-paid FICA taxes on tips
- Deferral of gain on involuntary conversions resulting from Presidentially-declared disasters

Employment

- Exclusion of miscellaneous fringe benefits
- Exclusion of employee awards
- Exclusion of income earned by voluntary employee beneficiary associations

Medicare

- Exclusion of untaxed Medicare benefits for Hospital Insurance
- Exclusion of untaxed Medicare benefits for Supplementary Medical Insurance

Treasury Tax Expenditures Not on the JCT ListEnergy

- Tax credit for electric vehicles
- Deductions for clean-fuel vehicles and refueling property
- Natural resources and environment
- Tax credit and seven-year amortization for reforestation expenditures

Agriculture

- Deferral of tax on gains from sale of stock in a qualified refiner or processor to an eligible farmer's cooperative

Financial Institutions

- Bad debt reserves of financial institutions

Insurance companies

- Special alternative tax on small property and casualty insurance companies
- Tax exemption for insurance companies owned by tax-exempt organizations

Business and commerce

- Ordinary income treatment of losses from sales of small business corporation stock
- Exclusion of income from discharge of indebtedness incurred in connection with qualified real property

Social Services

- Expensing of costs for removing architectural barriers

Endnotes

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11. Simons, *Personal Income Taxation*, p. 50.
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Increasing Transparency and Accountability for Tax Expenditures

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Mr. Chairman and other members of the Committee, thank you for the invitation to address you today. And thank you for S. 2590, the Federal Funding Accountability and Transparency Act of 2006. As Senator Coburn has said, "This public database will provide transparency to federal spending and will provide an important weapon taxpayers can use to hold the government accountable."

I urge this Committee to build upon its good work by extending the principles of accountability and transparency to what are referred to as "tax expenditures." The creation of a spending database only increases the importance of making tax expenditures transparent. Exposing spending proposals to public scrutiny, while continuing to leave the public largely in the dark about targeted tax proposals, could create an environment in which spending proposals that will not withstand scrutiny get transformed into tax proposals.

To avoid creating such an environment, this Committee may want to consider taking three steps:

1. Requiring government agencies to provide more detail about tax expenditures, including their magnitude and distribution across states, incomes, industries, and budgetary functions.²
2. Subjecting tax expenditures to the same performance and evaluation processes as spending proposals, including procedural reviews that apply to outlay programs.³
3. Extending the searchable internet database established by the Federal Funding Accountability and Transparency Act of 2006 to cover more tax expenditures, going beyond the Treasury and the Joint Committee on Taxation's (JCT) current practice of listing major entities that directly benefit from targeted tax expenditures. This information should be easily accessible through the same

¹ The views expressed in this testimony are mine alone.

² For more detail see the recommendations of the Century Foundation Working Group on Tax Expenditures, *Bad Breaks All Around*, Century Foundation Press, New York: 2002.

³ For more detail see the recommendations of the Government Accountability Office, "Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined," GAO-05-690, September 2005.

internet search engine that will be established pursuant to the Federal Funding Accountability and Transparency Act of 2006.

As the Government Accountability Office recently warned, “although tax expenditures are substantial in size, little progress has been made in the Executive Branch to increase the transparency of and accountability for tax expenditures.”⁴ Unless this situation is remedied, the Federal Funding Accountability and Transparency Act of 2006 will leave the public partially in the dark about the budgeting process and taxpayers will be unable to hold their government fully accountable.

In my testimony I will make five points to expand on the important of increasing transparency and accountability for tax expenditures.

First, the government allocates hundreds of billions of dollars annually through “tax expenditures”

One of the principal activities of government is *allocating* resources by taxing and spending. The government accomplishes this both in the process of raising revenues and in the process of spending. For example, if the government wants to allocate resources towards the production of \$1 billion worth of tanks it could appropriate the money and pay a weapons supplier \$1 billion in exchange for tanks. Alternatively, it could enact a \$1 billion “weapons supplier tax credit” and provide it to a defense contractor in exchange for the delivery of \$1 billion worth of tanks. Although our government accounting system treats these two exchanges differently – recording one as a spending increase and the other as a tax cut – they are essentially the same.

Similarly, the child tax credit could be converted into a spending program that mails \$1,000 checks to families with children that meet the income eligibility requirements. Or Social Security could be converted into program that provides refundable tax credits to senior citizens and other beneficiaries. In either case, the allocation and distribution of resources would be the same as under current law even though the budget would record the child tax change as an increase in taxes and spending and the Social Security change as a reduction in taxes and spending.

In recognition of this parallelism, the United States has adopted a statutory definition of “tax expenditures” as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability.”⁵ The concept of “tax expenditures” is also widely accepted among economists, lawyers and other policy analysts. For example, in testimony before the Entitlement Commission in 1994, then Federal Reserve Chairman Alan Greenspan urged the committee to address both what he called “tax entitlements” and spending entitlements in addressing the nation’s long-term fiscal problems.

⁴ GAO *op cit*.

⁵ Public Law 93-344, The Congressional Budget Act of 1974.

The Office of Management and Budget and JCT regularly release itemized reports on tax expenditures. In the last budget the Treasury listed a total of \$911 billion of tax expenditures in FY 2006, including \$807 billion for individuals and \$104 billion for corporations.⁶ This total approaches the total amount of discretionary spending (\$1,025 billion in FY 2006) and mandatory spending (\$1,418 billion in FY 2006).

Second, like normal expenditures, “tax expenditures” require higher taxes or reduction in other government spending

If the government approves a new \$1 billion spending project it will have two choices: raise taxes to pay for the project or cut other spending. (Borrowing postpones but does not alter these choices: the government will have to repay the debt by raising taxes or by cutting government spending.)

The financing choices for a new \$1 billion tax expenditure are identical: the government will have to raise taxes on everyone who is not specially favored by the tax expenditure or cut other spending.

To return to the earlier example, if Congress appropriates \$1 billion in spending for builders of tanks, it could raise taxes to pay for this expenditure, cut spending on, say, schools, or postpone the decision by borrowing the money. If the Congress enacts a \$1 billion weapons supplier tax credit the choices are identical. “Tax expenditures” are just as much “spending taxpayers money” as fiscal expenditures through the normal budget process.

In fact, if, for example, \$500 billion worth of tax expenditures were eliminated that would permit a 36 percent reduction in all individual and corporate income tax rates. Economists generally presume that a tax code with a broader base and lower rates will be more efficient and conducive to economic growth.

Third, tax expenditures raise additional concerns for fiscal policy

Tax expenditures raise additional issues beyond their fiscal cost including:

- *Creating the perception or reality of unfairness.* Tax expenditures can contribute to the perception or reality of unfair discrimination between taxpayers with similar abilities to pay.
- *Adding complexity.* Tax expenditures are an important part of the reason that the Internal Revenue Code runs to more than 6,000 pages, making filing taxes an unnecessarily complicated and burdensome process;

⁶ Note that these totals are indicative of the extent of tax expenditures but are not an estimate of the revenue that would be raised by repealing these tax expenditures because they ignore behavioral effects and the interaction of tax expenditures with other provisions in the tax code and other tax expenditures.

- *Disguising the true size of government.* The proper measure of the size of government is the degree to which it allocates and redistributes resources.⁷ Tax expenditures are responsible for allocating and redistributing substantial amounts of resources, yet they are accounted for as reductions in government revenues rather than increases in government outlays. As a result, although tax expenditures increase the government's intervention in the market economy the most common measure of the size of government records them as a reduction in the size of government.
- *In some cases, outlays may be more efficient than tax expenditures.* As GAO explains, "In some circumstances, tax expenditures may not be the best policy choice to deliver timely benefits or reach intended populations."⁸ For example, college aid may be delivered in a more timely and targeted fashion through Pell grants than through tax credits.
- *Reducing fiscal flexibility.* Tax expenditures, like entitlements, automatically provide benefits year after year. Unlike many outlay entitlements, tax expenditures do not even require reauthorization or any formal process to ensure that they are still serving their function.

Fourth, tax expenditures should receive the same scrutiny as government outlays.

Even though targeted tax expenditures have virtually the same impact as outlays on our federal budget and impose other impediments to sound fiscal policymaking, under current law they receive substantially less scrutiny than spending. Tax expenditures are not incorporated into the main budgetary tables prepared by the Office of Management and Budget (OMB) or the Congressional Budget Office (CBO). Even such basic data like the total size or distribution of tax expenditures by budgetary function is not currently available. Tax expenditures are not subject to annual budget reviews, periodic reauthorizations, or other tools of budgetary evaluation.

The Federal Funding Accountability and Transparency Act of 2006 will increase the scrutiny of government outlays still further. If the government spends \$1 billion purchasing tanks, the public will have easy internet access to the names of the entities receiving the payments, the amount of the award, and other related information. If the government enacts a \$1 billion weapons supplier tax credit the public has just as great an interest in knowing which entities are receiving the payment, the amount of the award and other related information, but under current law it is difficult to uncover that information.

The passage of this act *increases* the importance of extending transparency and accountability to tax expenditures. By increasing the scrutiny of spending programs the Act increases the incentive to shift spending for pet projects and entities to the tax side of the ledger. That way these projects or entities could evade the level of scrutiny that spending programs will

⁷ Daniel Shaviro, "The New Age of Big Government," *Regulation*, Spring 2004.

⁸ GAO, *op cit*.

receive. And if allocations for pet projects and entities is shifted to the tax side of the ledger, the tax code will grow even longer and more complicated.

Take H.R. 4520, The American Jobs Creation Act of 2004. It ran to 297 pages and included dozens of special tax breaks targeted at individual entities or small groups of entities that were not explicitly specified in the legislation. For example, the act “extended placed in service date for bonus depreciation for certain aircraft (excluding aircraft used in the transportation industry) ppisa [properly placed in service after] 9/10/01.”⁹ The provision, which cost more than \$247 million of the taxpayers’ money, reportedly was designed to benefit only one company: General Electric.

I have no personal judgment as to whether this particular provision was warranted or not. But it is my strong personal judgment that the public has a right to know about how much this provision costs and which company or companies benefit from it. I am not claiming that the \$911 billion in yearly tax expenditures are all wasteful or inappropriate. I am merely saying that their costs and beneficiaries ought to be known to the public. This is equally true whether a given tax expenditure assists only one entity or thousands of entities.

Fifth, attempts to increase transparency and accountability for tax expenditures should be mindful of concerns about privacy and other issues not faced by government outlays

One of my main recommendations – that the reporting of tax expenditures be extended to list the entities that benefit from them – raises some complications, but no insurmountable impediments. Some of the important issues to address include:

- *Privacy.* Americans are compelled to file tax forms. They are not compelled to apply for government grants. Thus there is an asymmetry between disclosing information about tax expenditures and information about grants. But this asymmetry should not be exaggerated. Spending also faces important privacy concerns that were successfully addressed in the Federal Funding Accountability and Transparency Act of 2006 by exempting individual recipients of Federal assistance (e.g., Social Security and food stamp beneficiaries) and government employees. A similar approach could be applied to taxes. Disclosing any individual tax expenditures, like medical deductions or mortgage interest deductions, would be a gross violation of privacy that would be contrary to the public interest. But our society accepts – and often requires – a certain level of financial disclosure by businesses. Entity-level reporting could be limited to business tax expenditures. This reporting could be further limited either to: (1) provisions that target benefits to a narrowly defined class of entities, (2) only entities with benefits from tax expenditures that exceed a specific dollar amount, like \$100,000, or (3) the top, say, 25 entities receiving each tax expenditure.
- *Ambiguity in the definition of tax expenditures.* There is some ambiguity in the definition of tax expenditures, whether an item represents a deviation from a broad-based tax or is part of administering that tax. This ambiguity, however, has not prevented Treasury or

⁹ Joint Committee on Taxation, JCX-69-04, October 4, 2004.

JCT from itemizing tax expenditures. Moreover, most of the tax expenditures targeted specifically at individual entities or modest numbers of entities are amenable to relatively uncontroversial definition.

- *Ambiguity in the measurement of tax expenditures.* There is also some ambiguity in the measurement of tax expenditures, particularly when considering the interaction of a variety of tax provisions. These ambiguities, however, are routinely overcome in compiling aggregate tax expenditures. Moreover, the calculated benefit — tax reduction — for the entities that receive a tax expenditure represent a useful piece of information for the public, even if tax economists could argue that the total budgetary cost is somewhat different from the benefit calculated by beneficiaries.
- *Access to the information required to compute tax expenditures.* Finally, the government already has a number of systems for tracking grant recipients. The Federal Funding Accountability and Transparency Act of 2006 merely requires the government to organize these data in a form that is accessible by the public. No such system is in place for tax expenditures. Thus there could be larger difficulties in compiling these data at the entity level, including a longer lag time between the tax expenditure and its recognition and inclusion in the database by the Internal Revenue Service (IRS). The restrictions discussed to protect privacy would also reduce the burden on the IRS of compiling a database on tax expenditures.

In conclusion, the basic principle should be to treat tax expenditures like other expenditures

The basic principle that should guide policymakers in approaching tax expenditures is parallelism: whenever possible tax expenditures should be subject to the same level of scrutiny, transparency and accountability as outlays. As Senator Lautenberg has said, “the American people deserve to know who is paying less in taxes and causing them to pay more. They have a right to know who is getting benefits from Congress.”

This is especially important because if one major part of the government’s fiscal system remains opaque it will undermine the broader intent of the Federal Funding Accountability and Transparency Act of 2006 — ensuring that the public is able to hold government accountable for its fiscal actions.

Failure to treat outlays and tax expenditures in a parallel manner could create pressure to transform spending programs into targeted tax entitlements, which receive less oversight. This will add to the existing pressure to rely on tax expenditures, whose popularity has grown in recent years, complicating the tax code and masking the true “size of government” as measured by the extent of its interference in the economy.

But applying the principle of parallelism will require balancing privacy and feasibility. Treasury and the IRS could both play an important role in developing options for increasing the transparency of tax expenditures. Some of those steps – such as reporting more data on the extent and distribution of tax expenditures – are relatively straightforward. Others will be more complicated. But exposing the specific entities that benefit from tax entitlements to the sunshine of public scrutiny is a goal which is well worth this Committee’s attention.

STATEMENT OF NEAL BOORTZ
CO-AUTHOR "THE FAIR TAX BOOK"
BEFORE THE _____ SUBCOMMITTEE

September 26, 2006

The last major overhaul of the U.S. tax system occurred in 1986. At that time many of the deductions that Americans had used to lower their annual tax burdens were removed and we were handed what was essentially a two-tiered flat tax system. This was sold to the American people as a tax simplification plan, but the reality was far different.

Since 1986 this alleged "simpler" tax code has been modified no less than 9000 times, often at the behest of K-Street lobbyists who earn incomes far above those of average Americans by inducing members of Congress to tinker with the tax code for the benefit of their clients.

We understand that the members of this committee are interested in exploring ways to make our tax code simpler and more transparent. Americans can only hope that the ultimate goal would make the tax code so easily understood that virtually every American taxpayer would have a clear picture of just how much of their hard-earned income is being transferred to the federal government in the form of taxes.

Today's tax code is anything but transparent to the average American, and one is left to wonder if this is not by design.

On the notorious day known as "Tax Day," April 15th an inquiry of a friend or co-worker as to how much taxes they paid for the preceding year will, more often than not, be met with the response "I didn't have to pay anything! I'm getting some back!"

With all due respect, I can't help but believe that the very thought of this response brings a broad smile to the face of many elected officials who view our tax system as a convenient way to not only fund the essential functions of our federal government, but also to acquire the funds necessary to purchase votes. Though I'm sure this doesn't apply to any of the members of this committee.

The current system of tax withholding merely serves to further obfuscate the impact of federal taxes on the average American worker. This is easily illustrated by asking a coworker or friend the simple question "How much do you make?" The most common response will be "None of your business." Those who do not choose to ignore your question will, more often than not, begin their answer with the phrase "I take home ..." and then plug in the appropriate figure.

Now if you're a rude and obnoxious radio talk show host you may well respond with "I didn't ask you how much you took home. I asked you how much you *made!*"

The message, though, is clear. Due to the intricacies of our current tax code most people have no clear idea as to what they make or how much they pay in taxes. Again, a politician's dream. Present company excepted, of course.

If a path to true tax transparency is the goal of this committee and these hearings, then the solution already exists in the form of The FairTax Act (H.R. 25, S 25) This legislation, first proposed by Georgia Republican Congressman John Linder, eliminates most of the taxes that so confound and confuse both individuals and businesses today.

Under the FairTax, personal and corporate income taxes would be eliminated, as would capital gains taxes, estate taxes, Social Security taxes, Medicare taxes and taxes on dividends. In the place of all of these taxes an imbedded national sales tax in the amount of 23%.

Let's be clear that this does not mean that the cost of all of these goods and services would increase by the amount of the new sales tax. Research shows that the amount of embedded taxes in these goods and services under our present code averages to 22%. One tax merely replaces the other.

If its tax transparency we want, consider this: Under the FairTax, when a consumer steps up to the cashier to purchase a \$100 toaster, the sales receipt he or she receives would clearly indicate that \$77 of the cost of that toaster is going to the retailer, with the remaining \$23 going to the federal government in the form of taxes.

What could be clearer?

No longer would American workers lack a clear understanding of how much they're paying in federal taxes. Every time they are handed a sales receipt it would be spelled out for them.

Likewise, no longer would the American worker have any doubt as to how much they were making. With no federal deductions from their paycheck the magic "take home" figure would, depending on deductions for state taxes, be the correct answer to the "how much do you make" question; that and the more appropriate "none of your business" response.

With the FairTax April 15th becomes just another day. Wouldn't it be nice if the American people could welcome the approach of spring without the dread of working on their tax returns?

The FairTax would address one of the other gaping problems with tax transparency in our current system. Though the average American spends around 57 hours a year doing the work necessary to complete and file a tax return, they consider this so much a part of their annual routine that they fail to calculate the cost of this lost time – time that amounts to nearly one and one-half work weeks. There have been many studies to determine the cost of tax compliance in America, and most estimates run at between \$300 and \$500 billion a year.

I understand that this committee seeks ways to open the public's eyes to proposed and actual changes in our tax code that are designed for the specific benefit of one or two private businesses. My listeners are often perplexed when I inform them that there is one tax law on the books crafted to benefit a specific manufacturer of ceiling fans.

Many ideas have been floated that were designed to paint a clearer picture of our tax laws to the average citizen, but no idea has been proposed that would simplify our tax picture more so than the FairTax.

Under the FairTax there is no necessity of developing a method to expose to public scrutiny tax changes favoring certain businesses or industries, because there would be no need for such changes in our code. Under the FairTax all American businesses, indeed all Americans would conduct their daily economic affairs with no tax component whatsoever on capital and labor.

Under the FairTax the federal tax picture would be crystal clear to all, businesses and wage earners alike. Business leaders would be able to concentrate their decision making on what is best for their business, their employees and their shareholders. Individuals would be able to save and invest with no tax consequences. You spend, you are taxed. You save, you are not.

Just a few points in closing.

The thought of a 23% retail sales tax on all consumer goods and services would sound horrifying to those in our lowest income quintile.

First, we must remember that the sales tax merely replaces the imbedded tax already present in these goods and services.

Secondly, the FairTax relieves all households of the responsibility for paying sales taxes on the basic necessities of life through a rebate system.

The FairTax is truly the only tax reform plan that completely eliminates the responsibility for the payment of any federal taxes whatsoever on the poor.

In closing, let me say that my somewhat unique position as a radio talk show host with 36 years under my broadcasting belt affords me a good vantage point from which to gauge the appeal of the FairTax to the average American taxpayer.

If I ever want to sit back and take it easy for a day, all I have to do is mention the FairTax on my show. The phone lines are instantly flooded with people eager to learn more and lend their support. Extensive research by my radio employer has shown that the FairTax sits at the top of the list of subjects my listeners want to discuss.

We have also seen that the FairTax, at least in my home state of Georgia, drives voters to the polls. In the recent Georgia primary election I mentioned on the air that the FairTax was on the ballot in no less than three metro Atlanta counties. Not only did people vote for the FairTax by over 85% in all three counties, but I received no less than a dozen letters and emails from listeners who said that they had no intention of participating in the primary until they heard that the FairTax was on the ballot.

In one instance a man wrote to tell me that he was taking his wife home from dental surgery. Four wisdom teeth bit the dust on that day, yet upon hearing that the FairTax was on the ballot in her county, this lady insisted that her husband take her by her voting precinct before she went home to recuperate.

My listeners coast-to-coast would join with me in commending the work of this subcommittee in looking for a way to make our tax laws easier to understand. There is no better solution than the FairTax.

Thank you very much for allowing me to appear before you today;