Written Statement of Nina E. Olson
National Taxpayer Advocate

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U.S. House of Representatives

On

The IRS and the Tax Gap

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1. Congress should consider revising its budget rules in a manner that allows the budget and appropriations committees to make a judgment about the answer to the question: "What level of funding will maximize tax compliance, particularly voluntary compliance, with our nation's tax laws, with due regard for protecting taxpayer rights and minimizing taxpayer burden?" and then set the IRS funding level accordingly, without regard to spending caps. 13

2. In allocating IRS resources, Congress should keep in mind that tax compliance is a function of both high quality taxpayer service and effective tax-law enforcement, and it is essential that the IRS continue to maintain a balanced approach to improving tax compliance. 15

3. Congress should provide increases in IRS personnel funding at a steady but gradual pace, perhaps two percent to three percent a year above inflation. We do not think the IRS can ramp up its staffing more quickly without encountering significant transitional difficulties. However, Congress should consider providing more rapid funding increases for technology and research improvements, as the transitional challenges of absorbing additional resources are probably less significant in these areas and the potential exists to generate substantial productivity gains. 17

4. To assist Congress in performing its oversight responsibilities and determining the appropriate IRS funding level in future years, Congress should require the IRS to provide annual or semiannual reports detailing IRS's progress in handling all significant categories of work, including the known workload, the percentage of the known workload the IRS is able to handle and the percentage of the known workload the IRS is not able to handle, the additional resources the IRS would require to perform the additional work, and the likely return-on-investment of performing that work. 18

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Mr. Chairman, Ranking Member Ryan, and distinguished Members of the Committee:

Thank you for inviting me to testify today about "The IRS and the Tax Gap."[1] In the National Taxpayer Advocate's 2006 Annual Report to Congress, issued last month, I made a recommendation to address the tax gap that falls squarely within the jurisdiction of the Budget Committee – namely, to change the budget rules by which IRS funding decisions are made to provide funding at whatever level will maximize tax compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. I will describe my proposal in more detail below after first summarizing the components of the tax gap and describing my perspective on the best strategies to address it.

I. Why the Tax Gap Matters

In my 2006 report, I designated the tax gap as the second most serious problem facing taxpayers (after the alternative minimum tax). From a taxpayer perspective, I am deeply concerned that compliant taxpayers are paying a great deal of money to subsidize noncompliance by others. Using data from the IRS's 2001 National Research Program study, if we divide the estimated 2001 net tax gap of $290 billion[2] by the estimated 108,209,000 households that existed in the United States in that year[3] we see that each household was effectively assessed an average "surtax" of about $2,680 to subsidize noncompliance.[4] That is an extraordinary burden to ask our nation's compliant taxpayers to bear every year, and it is imperative that we take steps to reduce that burden.[5]

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[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] *See* IRS News Release 2006-28, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts). The National Research Program study estimated that the "gross tax gap" was about $345 billion and the "net tax gap" (*i.e.,* the gross tax gap reduced by late payments and amounts collected as a result of IRS enforcement actions) was about $290 billion. The IRS's most current estimate of the tax gap is based primarily on audits it conducted on tax returns filed for 2001.

[3] U.S. Census Bureau, Population Division (data as of March 2001).

[4] The IRS's most current estimate of the tax gap is based primarily on audits it conducted on tax returns filed for 2001.

[5] Significantly, the IRS Oversight Board reports there is substantial public support for an enhanced IRS compliance program provided that it is balanced. The Oversight Board conducts an annual survey of taxpayer attitudes and found that two-thirds of taxpayers support additional funding for both IRS assistance and enforcement. *See* IRS Oversight Board, *2005 Taxpayer Attitude Survey*.

Noncompliance has a corrosive effect on tax compliance. If compliant taxpayers believe that everyone else is paying his or her fair share, they are likely to remain compliant. But no one wants to feel like a "tax chump." If compliant taxpayers feel like they are overpaying, some will reach a point where they resent it and stop complying or comply at a lower level.

In other words, there is a degree to which compliance breeds more compliance and noncompliance breeds more noncompliance. That is largely why each additional dollar the IRS collects is thought to increase federal revenue by substantially more than a dollar. Greater compliance – whether brought about through taxpayer service or enforcement – can pay for itself many times over.

II. Overview of the Primary Causes of the Tax Gap

Last year, the IRS substantially updated its tax gap estimates as a result of a set of audits it performed on individual income tax returns filed for 2001. The results of the audits show that withholding and third-party information reporting are the key drivers of tax compliance. Reporting compliance rates are about 99 percent on wages subject to withholding and third-party information reporting, about 96 percent on income subject to full third-party information reporting (*e.g.,* interest and dividends) – yet less than 50 percent on income *not* subject to third-party information reporting.[6]

At the same time, the complexity of the tax code is a driver of noncompliance because it creates loopholes that aggressive taxpayers can exploit. Corporate tax shelters and abusive schemes pursued by individual taxpayers exist largely because of ambiguities in the law. Tax-law or procedural complexity is also responsible for the significant majority of taxpayer reporting errors.[7]

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

[7] 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. 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. Internal Revenue Service (unpublished data from National Research Program). The precision of these data may be open to question because it is impossible for an auditor to determine the intent of a taxpayer at the time the taxpayer prepared a return. In the absence of contrary data, however, these data at a minimum should persuade IRS to conduct significant new studies on the causes of noncompliance. A separate study by the Government Accountability Office analyzed the misreporting of capital gains transactions. The study concluded that 33 percent of taxpayers who misreported their income from securities transactions reported more capital gains than they actually realized. 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 tended to cause overpayments of tax (and thus were clearly inadvertent) implies that an equal percentage of inadvertent errors caused taxpayers to underpay their tax – or, put differently, that 66 percent of all errors in capital gains misreporting were inadvertent and only 34 percent were intentional. Government Accountability Office, Ref. No. GAO-06-603, *Capital Gains Tax Gap: Requiring Brokers to Report*

Finally, the lack of funding provided to the IRS to maximize taxpayer service (especially outreach and education) and enforcement (where the IRS was only able to conduct face-to-face audits of one out of every 435 taxpayers last year) prevents the IRS from maximizing tax compliance.[8]

III. Broad Strategies to Address the Tax Gap

Broadly speaking, I have advocated three strategies for closing the tax gap: (1) fundamental tax simplification, with an emphasis on making economic transactions more transparent; (2) expanded third-party information reporting and, in certain situations, tax withholding on non-wage income; and (3) a more robust IRS compliance program that appropriately balances taxpayer service and enforcement.

A. Tax Simplification

In my annual reports to Congress, I have highlighted numerous examples of tax law complexity and described the consequences of that complexity for taxpayers and tax administration. For taxpayers seeking to comply with the law, complexity presents a huge obstacle. To cite a few examples, the alternative minimum tax (AMT) and the earned income tax credit (EITC) affect millions of taxpayers yet present substantial compliance burdens. The sheer number of alternative incentives that the tax code provides for saving for education and retirement baffles many taxpayers, including sophisticated taxpayers.

For taxpayers seeking to exploit loopholes, complexity presents countless opportunities. Many law firms, accounting firms, and investment banking firms have made tens of millions of dollars by scouring the Code for ambiguities and then advising taxpayers to enter into transactions, with differing levels of business purpose or economic substance, to take advantage of those ambiguities. The IRS devotes significant resources to identifying these transactions and challenging them, where appropriate, but many are legitimate under existing law and many more fall into a grey area.

A simpler tax code could reduce these administrative challenges enormously.

Moreover, traditional economic analysis focuses on the goals of equity and efficiency in writing the tax laws. To those, I would add transparency. To the extent we can revise the Code to provide greater transparency of payments of income without imposing undue burden on taxpayers, the higher compliance rates associated with third-party information reporting can be more readily achieved in a broader array of transactions.

Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed at 12 (June 2006).

[8] Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006).

B. Expanded Third-Party Information Reporting

Expanding third-party information reporting would clearly improve compliance, but we must be realistic in taking into account the burden third-party information reporting imposes on payors of income. If our sole objective were to maximize the amount of tax revenue, we could simply require that anyone making a taxable payment to another person report the payment to the IRS. But requiring everyone making a taxable payment to file a report with the government would impose more burden than most of us would be willing to bear. No one wants to be obligated to file a document with the IRS every time he takes a cab ride, has someone mow his lawn, or calls a plumber to fix a broken faucet.

To address the tax gap, we should begin by identifying 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. In many cases, we will ultimately decide that it is inappropriate to impose a reporting requirement. But in some cases, we may decide that requiring reporting is appropriate.

To cite one example, I recommended in my 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, the absence of cost-basis reporting provides an opportunity for noncompliance that the IRS rarely will detect without an audit.

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 compliance much easier for honest taxpayers.

But the second consequence of the absence of cost basis reporting is that it affords less honest taxpayers with significant opportunities to overstate their basis and therefore understate their tax liabilities. Reliable estimates of the amount of underreporting in this

area are difficult to come by, but two professors have sized the problem at about $25 billion a year.[9] IRS officials studying the NRP data believe the revenue loss is substantially lower, but they agree that the level of underreporting reaches into the billions of dollars.[10] 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.

I am pleased that bills were introduced in both the House and the Senate last year to implement our proposal, and I am pleased that the Treasury Department has included it among the revenue proposals it sent to Congress earlier this month. Bipartisan bills have been introduced in the new Congress by Congressmen Rahm Emanuel and Walter Jones in the House and by Senators Evan Bayh, Tom Coburn and 11 other original co-sponsors in the Senate. I strongly urge Congress to enact this measure.

Another example: 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.

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 Form 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 Form 1099-MISC reporting requirements to the same extent that unincorporated businesses are today.

We also recommend that Congress consider requiring information reporting on gross proceeds from sales conducted on Internet auction and sales 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.[11] The IRS must have the tools needed to address under-reporting of this income.

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

[10] *See* Department of the Treasury, General Explanation of the Administration's Fiscal Year 2008 Revenue Proposals 64 (February 2007). Treasury provides a 10-year revenue estimate of just $6.7 billion. We note, however, that Treasury's proposal would not take effect until 2009, and it would only require basis reporting with regard to securities purchased after that date. In the early years, many securities sold would have been purchased prior to the effective date of the proposal and thus would be exempt from reporting.

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

My office has made a number of proposals to reduce the tax gap both through more third-party information reporting and through other methods. The Exhibits that follow my statement summarize our main recommendations.

C. A More Robust IRS Compliance Program That Appropriately Balances Taxpayer Service and Enforcement Measures

The IRS can do more – much more – to improve tax compliance.

Despite a finding by a leading IRS researcher that the direct and indirect benefits of IRS's preparing tax returns for low income taxpayers pays for itself many times over,[12] the IRS has reduced by about half the number of tax returns it helps low-income taxpayers prepare in its walk-in sites.[13] Despite the challenges individuals who start small businesses face in learning for the first time about the legal requirements they face as employers (including the payroll responsibilities of income and employment tax withholding, paying over tax to the IRS, reporting to the IRS, and reporting to the employee), the IRS has substantially reduced its field outreach operation.[14] Despite the number of taxpayers in certain states with taxable income from farming activities, the IRS has apparently declared questions about farm income and expenses "out of scope" for IRS walk-in sites in those areas.[15]

On the enforcement side, the IRS is currently conducting face-to-face audits of only about one out of every 435 tax returns.[16] It does not have the resources to pursue a significant percentage of its accounts receivable. And the private debt collection initiative, a controversial program that is projected to raise only about $1.4 billion over the next 10 years,[17] results from the IRS's lack of resources to pursue these cases itself.

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[12] *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).

[13] IRS Wage & Investment Operating Division, *Business Performance Review, Wage and Investment Operating Division, FY 2006*; IRS Wage & Investment Operating Division, *Business Performance Review, Wage and Investment Operating Division, FY 2005*; IRS Wage & Investment Operating Division, *Business Performance Review, Wage and Investment Operating Division, FY 2004*; IRS Wage & Investment Operating Division, *Business Performance Review, Wage and Investment Operating Division, FY 2003.*

[14] IRS Small Business/Self Employed Operating Division, Response to Taxpayer Advocate Information Request (Sept. 5, 2006).

[15] This concern was raised by a taxpayer during a 2006 Town Hall meeting with the National Taxpayer Advocate in Fargo, North Dakota.

[16] Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006).

[17] *See* IRS News Release IR-2006-42, *IRS Selects Three Firms to Take Part In Delinquent Tax Collection Effort* (March 9, 2006).

IV. A Proposal to Revise the Congressional Budget Rules to Improve IRS Funding Decisions

A. Overview of the Problem of IRS Underfunding

The Internal Revenue Service is effectively the Accounts Receivable Department of the United States Government. On a budget of about $10.6 billion,[18] the IRS currently collects about $2.24 trillion a year.[19] That translates to an average return-on-investment (ROI) of about 210:1.[20]

Rather than recognizing the IRS's unique role as the revenue generator for the federal government, however, the congressional budget rules treat spending for the IRS exactly the same way they treat spending for all other federal agencies.

The current budget procedures work essentially as follows: Early each year, a spending ceiling is established for a category of programs that in recent years included the Department of Transportation, the Department of the Treasury (of which the IRS is a part), the Department of Housing and Urban Development, the Judiciary, the District of Columbia, and independent federal agencies.[21] The House and Senate Appropriations subcommittees with jurisdiction over this grouping of federal programs must apportion the total number of dollars it receives among them. If more funding was provided for transportation programs, for example, less funding was available for the IRS. Thus, the IRS competes dollar-for-dollar against many other federal programs for resources.

These procedures make little sense. The IRS collects about 96 percent of all federal revenue.[22] The more revenue the IRS collects, the more revenue Congress may spend on other programs or may use to cut taxes or reduce the deficit. The less revenue the IRS collects, the less revenue Congress has available for other purposes.

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[18] Department of the Treasury, *FY 2007 Budget in Brief* at 59.

[19] Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* at 95 (Nov. 2006). The IRS actually collected $2.51 trillion on a gross basis in FY 2006, but issued $277 billion in tax refunds.

[20] When collecting tax from the vast majority of taxpayers who file returns and pay all or substantially all of the tax they owe voluntarily, the cost the IRS incurs per taxpayer is very low. As the IRS attempts to collect tax from noncompliant taxpayers through broader outreach efforts or through examination and collection actions, the cost per taxpayer rises substantially. Therefore, the *marginal* ROI the IRS achieves as it attempts to collect unpaid taxes is likely to be considerably lower than the *average* ROI of 210:1 that the IRS achieves on taxes paid voluntarily. But if the IRS were given more resources, most data indicate that the IRS could generate a substantially positive marginal ROI.

[21] In the current Congress, the Appropriations subcommittees have been restructured, and the IRS will be funded through the Appropriations Subcommittee on Financial Services and General Government.

[22] Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 68 (Nov. 2006).

If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at a level that it believed would maximize the company's bottom line.

Since the IRS is not a private company, maximizing the bottom line is not – in and of itself – an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. If the IRS were given more resources, studies show the IRS could collect substantially more revenue.

Former IRS Commissioner Charles Rossotti has written:

> When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of the job, by far, was dealing with the IRS budget. The reaction was usually "Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn't you be able to get it?"[23]

Yet obtaining a little extra money to bring in a lot of extra money remains an intractable challenge for the IRS. Over the past few years, Congress has focused increasing attention on the "tax gap" – the difference between taxes owed and taxes paid. As part of this discussion, it should be recognized that the IRS currently suffers from a "resources gap," and the IRS's lack of resources is a significant impediment to its ability to help close the tax gap and thereby reduce the federal budget deficit.[24]

B. The Consequences of Underfunding the IRS

The failure to fund the IRS at appropriate levels leads to two sets of consequences. First, the IRS lacks the resources to collect a significant amount of unpaid tax, resulting in a larger tax gap and a larger budget deficit. Second, the lack of resources often leads the IRS to take steps that are, in my judgment, unwise from the standpoint of tax compliance and taxpayer rights.

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[23] Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 278 (2005). On pages 278-286, Mr. Rossotti presents an interesting personal perspective on the budget process and the politics behind the chronic under-funding of the IRS.

[24] The chairman and ranking member of the Senate Budget Committee supported additional funding for the IRS in the FY 2007 budget resolution. Senator Judd Gregg acknowledged that the existing budget procedures have the effect of shortchanging the IRS. He said: "We've got to talk to the [Congressional Budget Office] about scoring on [additional funding provided to IRS]. Clearly there's a return on that money." Dustin Stamper, *Everson Pledges to Narrow Growing Tax Gap,* 110 Tax Notes 807 (Feb. 20, 2006). Similarly, Senator Kent Conrad stated: "Rather than a tax increase, I think the first place we ought to look . . . is the tax gap. If we could collect this money, we'd virtually eliminate the deficit." Emily Dagostino, *Senate Budget Resolution Would Increase IRS Enforcement Funding,* 110 Tax Notes 1129 (Mar. 13, 2006).

1. Failure to Collect Unpaid Taxes

In his final report to the IRS Oversight Board in 2002, former Commissioner Rossotti presented a discussion titled "Winning the Battle but Losing the War" that detailed the consequences of the lack of adequate funding for the IRS. He identified 11 specific areas in which the IRS lacked resources to do its job, including taxpayer service, collection of known tax debts, identification and collection of tax from non-filers, identification and collection of tax from underreported income, and noncompliance in the tax-exempt sector.

Commissioner Rossotti provided estimates of the revenue cost in each of the 11 areas based on IRS research data. In the aggregate, the data indicated that the IRS lacked the resources to handle cases worth about $29.9 billion each year. It placed the additional funding the agency would have needed to handle those cases at about $2.2 billion.[25]

Significantly, this estimate reflects only the potential *direct* revenue gains. Economists have estimated that the indirect effects of an examination on voluntary compliance provide further revenue gains. While the indirect revenue effects cannot be precisely quantified, two of the more prominent studies in the area suggest the indirect revenue gains are between six and 12 times the amount of the proposed adjustment.[26]

I want to emphasize that the existing modeling in this area is not especially accurate, and estimates of both the direct and indirect effects of IRS programs vary considerably. As I will discuss below, the IRS needs to develop better modeling to produce more accurate return-on-investment estimates. But I also want to emphasize that almost all studies show that, within reasonable limits, each additional dollar appropriated to the IRS should generate substantially more than an additional dollar in additional federal revenue assuming the funding is wisely spent.

2. Bad Results

a. Outsourcing Tax Collection

In the same report, former Commissioner Rossotti reported the IRS was receiving sufficient resources to work only 40 percent of some 4.5 million accounts receivable cases each year. IRS research estimated that with an additional $296.4 million, the agency could collect $9.47 billion.[27] That translates to a return on investment of 32:1.

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[25] Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002).

[26] 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).

[27] Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002).

Among collection cases handled solely through phone calls, the IRS has estimated an ROI of about 13:1.[28]

Because Congress has not provided IRS with sufficient funding to work these accounts, the Administration requested the authority to outsource the collection of certain tax debts to private collection agencies. Congress granted the requested authority in 2004,[29] and the IRS began to send cases to private debt collectors in September of 2006.

Under the terms of the program, the IRS is paying out commissions of up to 25 percent of each dollar collected to the private collection agencies. The IRS is also bearing significant additional costs to create, maintain, and oversee the program.[30]

Internal IRS estimates show that the IRS, if given the funding, could generate a substantially higher ROI than private contractors receiving commissions of nearly 25 percent can produce. For each dollar a PCA collects, the IRS will receive about 75 cents and the PCA will keep about 25 cents, resulting in an ROI of, at best, about 3:1. The significant administrative costs the IRS is incurring to run the program, including the opportunity costs of pulling experienced IRS personnel off higher dollar work to assist with this initiative, reduce the ROI further. Despite supporting the use of private debt collectors because of IRS resource limitations, IRS Commissioner Mark Everson has repeatedly acknowledged that IRS employees could collect unpaid taxes more cheaply and efficiently.[31]

The result of underfunding the IRS in this area is that the government is not maximizing its revenue collection and the risk of taxpayer rights violations has been heightened due to the use as collectors of non-governmental employees who will receive only limited taxpayer-rights training.[32]

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[28] Government Accountability Office, GAO-06-1000T, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches,* at 17 (July 26, 2006).

[29] Pub. L. No. 108-357, § 881(a)(1) (enacting IRC § 6306).

[30] For a detailed discussion of the private debt collection program, *see* National Taxpayer Advocate 2006 Annual Report to Congress at 34-61 (Most Serious Problem: *True Costs and Benefits of Private Debt Collection)*.

[31] *See, e.g.,* Dustin Stamper, *Everson Admits Private Debt Collection Costs More, Defends Return Disclosure Regs,* 111 Tax Notes 11 (Apr. 3, 2006).

[32] Senator Max Baucus recently highlighted another example of the counterproductive impact of shortchanging IRS funding. In FY 2006, Congress imposed a one-percent across-the-board funding rescission on domestic discretionary spending, and the IRS absorbed a reduction of about $100 million as a consequence. Citing GAO data, Senator Baucus estimated that the $100 million in "savings" would ultimately cost the U.S. Treasury about $1 billion in lost tax collections. He stated: "[E]ven small reductions in collection and taxpayer services are penny-wise, pound-foolish. Sparing the IRS budget may be the best way to bring in more owed revenue and end deficit spending." News Release, Senator Max Baucus, *$100 Million Budget Cut to IRS May Cost $1 Billion or More in 2006 Tax Collections* (May 22, 2006).

b. Neglect of Important Taxpayer Service Programs

The IRS has long acknowledged that taxpayer service plays a significant role in promoting tax compliance. In fact, its current strategic plan is based on the principle: "Service + Enforcement = Compliance."[33] Yet two examples illustrate the neglect of important services that likely is resulting in a higher tax gap.

Tax Return Preparation. The IRS historically has prepared tax returns for low income taxpayers at its walk-in sites (called "Taxpayer Assistance Centers," or "TACs"). Low income taxpayers generally qualify for the earned income tax credit (EITC), which is a refundable credit that caps out at $4,536 in 2006. Studies show that the average overclaim rate for EITC benefits is between 27 percent and 32 percent.[34] IRS personnel who prepare tax returns are trained to ask questions that minimize the likelihood of EITC overclaims and thus can save the government hundreds of dollars per return. Yet to free up resources for other program initiatives, the IRS has substantially reduced return preparation at its TACs. The number of tax returns it prepared dropped from 665,868 in FY 2003 to a projected 305,000 in FY 2006.

IRS data for tax years 2002 through 2004 suggest that EITC returns prepared by IRS TACs may be significantly more compliant than self-prepared and commercially prepared returns. Discriminant Function (DIF) scores[35] for self-prepared returns were between 21 and 26 percent higher than returns prepared at the TACs and between 25 and 31 percent higher than returns prepared by commercial preparers.[36]

These findings are corroborated by examination results for EITC returns for these tax years. As compared with TAC-prepared returns, average audit assessments among EITC returns for tax years 2002 - 2004 ranged from about $640 to $1,300 higher for self-prepared returns and from about $820 to $1,300 higher for commercially prepared returns.[37] Similarly, a study conducted in 1996 that examined the relationship between

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[33] In the preface to the National Taxpayer Advocate 2006 Annual Report to Congress, I argue that compliance should be viewed as a third category or IRS emphasis rather than as the sum of service and enforcement. There are many compliance activities the IRS undertakes, such as document matching, that catch errors taxpayers make either inadvertently or negligently. In my view, these activities should be classified as "compliance" activities, and the "enforcement" label should be reserved for cases of willful violation of the laws. I argue that nomenclature matters in this area because if the IRS treats willful and inadvertent compliance the same way, IRS personnel will treat innocent taxpayers harshly and taxpayers will feel that the IRS has dealt with them unfairly, perhaps alienating them from the tax system and reducing their future compliance.

[34] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns 3 (Feb. 28, 2002).

[35] The DIF score is an estimate of the likelihood of non-compliance on a return. A higher score indicates a higher likelihood of non-compliance.

[36] IRS Compliance Data Warehouse, Individual Returns Transaction File data for tax years 2002-2004.

[37] IRS Compliance Data Warehouse, Audit Inventory Management System data for tax years 2002-2004.

IRS return preparation and compliance over a ten-year period showed that an increase in the number of returns prepared by the IRS correlates with improvements in compliance among filers of individual returns.[38]

Small Business Outreach. IRS data show that self-employed taxpayers account for the largest chunk of the tax gap and indicate that the tax compliance rate for self-employed taxpayers runs at about 43 percent.[39] Much of the underreporting is deliberate, but some is not. For example, many small businesses are started by individuals who lack detailed knowledge of the tax laws and do not have the resources to hire tax attorneys or accountants. When they hire a few workers, they often do not realize that they are assuming tax reporting, tax withholding, and tax payment obligations, and they often do not understand enough about the details of complying with the requirements to do so with reasonable effort.

After the IRS Restructuring and Reform Act of 1998, the IRS developed a function known as Taxpayer Education and Communications, or "TEC." TEC was the IRS's outreach arm to small businesses to try to educate them about the complexity of their tax obligations. For 2002, TEC was named the Small Business Administration's agency of the year for what the SBA called its outstanding progress in creating an effective education and compliance assistance program for small business and self-employed taxpayers.[40] Yet in the name of achieving "efficiencies," TEC was "realigned" in February 2005 through a merger with other outreach functions and redesignated as "Stakeholder Liaison." Prior to the realignment, TEC had 536 employees. After the realignment, Stakeholder Liaison staffing included 219 employees.[41] In my view, the reduction in TEC staffing will reduce tax compliance and place a greater burden on IRS enforcement personnel.

I cite these examples to make two points. First, although I disagree with certain decisions the IRS has made, the failure to provide the IRS with adequate resources to collect taxes has forced the IRS to cut corners in places where corners should not have to be cut. Second, I cite the examples of tax return preparation and TEC to underscore the important role taxpayer service plays in promoting tax compliance. As I discuss below, additional funding for the IRS should be provided in a balanced manner. The revenue derived from direct enforcement actions may be easier to measure, but the effects of taxpayer service may be equally significant and perhaps more significant.

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[38] *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).

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

[40] *See Closing the Tax Gap and the Impact on Small Business,* Hearing Before the House Comm. on Small Business, 109th Cong. (Apr. 27, 2005) (testimony of John Satagaj, President and General Counsel, Small Business Legislative Council).

[41] IRS Small Business/Self Employed Division response to Taxpayer Advocate Service Information Request (Sept. 5, 2006).

C. Recommendations

1. Congress should consider revising its budget rules in a manner that allows the budget and appropriations committees to make a judgment about the answer to the question: "What level of funding will maximize tax compliance, particularly voluntary compliance, with our nation's tax laws, with due regard for protecting taxpayer rights and minimizing taxpayer burden?" and then set the IRS funding level accordingly, without regard to spending caps.

This recommendation, in my view, boils down to simple common sense. Just as a business could not survive if it did not seek to maximize revenue collection, the federal government has less revenue to spend (or use to reduce the deficit or cut taxes) if it fails to optimize tax collection. Taxes are truly the lifeblood of government, for without tax revenue, there would be no government programs. As the National Taxpayer Advocate, I will be the first to raise objections if the pursuit of revenue proceeds without due regard for protecting taxpayer rights and minimizing taxpayer burden. But the existing budget rules, which pit the revenue center of the government in direct competition with cost centers and do not have a mechanism for explicitly taking into account the revenue the IRS is likely to generate, are not logical. The congressional budget rules are the one piece of the tax gap over which your committee has direct control, and I urge you to consider improvements to the process.

One way to implement the proposal I have outlined would be to keep the IRS within its existing appropriation bill but break that bill into two parts – one providing a funding cap for the IRS and one providing a funding cap for all other programs under that bill. The budget committees would set the funding cap for the IRS.[42] The appropriations committees then would retain discretion to appropriate funds at the cap or at a lesser level and to provide direction concerning how the funds are to be spent. The rules should explicitly authorize the committees to set the cap at a level that they believe will maximize tax compliance, especially voluntary compliance, with due regard for the protection of taxpayer rights and minimization of taxpayer burden. In setting the cap and making funding decisions, the budget and appropriations committees would consider the President's budget request as well as input from the tax-writing committees, the Congressional Budget Office, the Joint Committee on Taxation, the Government Accountability Office, the Congressional Research Service and any other office that they choose to consult to obtain revenue estimates and guidance concerning the likely return on IRS spending.

We offer this approach only as an illustration of a way to implement the general principle we are recommending. We do not have sufficient expertise in the congressional budget process to craft a comprehensive solution, and we are cognizant of the important roles

[42] Two caps would have to be established for total appropriations – one for the IRS and one for all other discretionary spending.

that the budget committees, the appropriations committees, and the tax-writing committees play. Our overriding recommendation is simply that the committees of jurisdiction collaborate to devise and implement procedures that reflect the general principles we have outlined.

We note that in each of the past three years, the Administration has proposed a contingent budgetary mechanism known as a "program integrity cap" in an attempt to provide the IRS with additional funding. Under this mechanism, additional funding for tax-law enforcement would have been provided if, but only if, Congress agreed to fund at least the existing base of enforcement activities. The Senate has endorsed the concept, but the House did not go along. Although there may have been subtle differences in detail, a similar approach was used in FY 1995 to give the IRS additional funding.[43] Because the Budget and Appropriations committees have become familiar with this mechanism, it may be a viable way to channel additional funding to the IRS.

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[43] For FY 1995, the congressional budget resolution provided for an adjustment of budget resolution spending levels to allow additional funding for an "Internal Revenue Service Compliance Initiative." H. Con. Res. 218, 103rd Cong. § 25 (1994). The provision authorized an adjustment to reflect amounts of additional new budget authority or additional outlays of up to $405 million per year provided certain conditions were met. Although there is no indication the initiative failed or generated strong opposition, control of Congress changed the next year and the provision was subsequently repealed. H. Con. Res. 67, 104th Cong. § 209 (1995). The joint explanatory statement accompanying the conference report on the FY 1995 budget resolution provision (which originated as Section 54 of the Senate amendment to the House-passed budget resolution) provided additional information about the specifics of the approach:

> Section 54 of the Senate amendment allows for additional appropriations for an Internal Revenue Service Compliance initiative. If the Congress appropriates the base amounts requested for the Internal Revenue Service in the President's budget for fiscal year 1995 and a variety of other conditions are met, then Congress can also appropriate additional amounts for a compliance initiative without triggering points of order that might otherwise lie against such legislation.
>
> Under sections 54(a) and 54(b) of the Senate amendment, upon the reporting of an appropriation bill funding the compliance initiative and the satisfaction of the conditions listed, the Chairman of the appropriate Budget Committee must file revised appropriations caps, allocations to the Appropriations Committee, functional levels, and aggregates to clear the way for the incremental spending for the initiative. This procedure parallels that used in reserve funds . . . , which allow deficit-neutral legislation to proceed without points of order even if that legislation pays for direct spending with revenues. Similarly, section 54 of the Senate amendment allows appropriations legislation to proceed without points of order if it is demonstrated that the revenues raised by those appropriations would offset the costs of the appropriations.
>
> The first parenthetical language in the matter after subsection (a)(3) establishes the first condition precedent, that the Congress appropriate the base amounts requested for the Internal Revenue Service in the President's Budget for fiscal year 1995. Subsection (d) lists the other conditions: enactment of a Taxpayer Bill of Rights 2, initiation of an Internal Revenue Service educational program as mandated by the Taxpayer Bill of Rights 1 and 2, a finding by the Congressional Budget Office that by virtue of revenues raised, the appropriations will not increase the deficit, and a restriction of funds made available pursuant to this authority to carrying out Internal Revenue Service compliance initiative activities.
>
> The House resolution contains no such provision.

However, we have two concerns about the use of program integrity caps. First, the mechanism operates simply to mitigate the effects of what we are arguing is a flawed conceptual approach to funding the IRS. It would not alter the existing framework under which the IRS competes for funding against other government programs, and it would not peg future IRS funding decisions to the goal of maximizing tax compliance. I believe a change to the process along the lines of what I am recommending would be far preferable in the long run and would be more likely to result in a consistent ramp-up in funding year-over-year. Second, the mechanism in the past has been proposed solely to boost enforcement spending (*i.e.,* the additional funding could be used only for tax-law enforcement and would only be provided if Congress agreed to fund at least the existing base of enforcement activities). As discussed below in more detail, tax compliance is a function not only of enforcement but also of taxpayer service, and it is important to maintain a balanced approach between the two. If program integrity caps are used in the future, we urge that consideration be given to providing additional funding for taxpayer service as well as enforcement.

2. In allocating IRS resources, Congress should keep in mind that tax compliance is a function of both high quality taxpayer service and effective tax-law enforcement, and it is essential that the IRS continue to maintain a balanced approach to improving tax compliance.

As noted, recent attempts to give the IRS additional funding beyond the levels provided under the spending caps have focused exclusively on providing additional funding for enforcement activities. That is so largely because the *direct* ROI resulting from enforcement actions is somewhat susceptible to measurement, while the deterrent effect of enforcement actions and the effect of taxpayer service are too amorphous to quantify. However, it is important to emphasize that direct enforcement revenue in FY 2006 came to only $48.7 billion, or 2 percent, of total IRS tax collections of $2.24 trillion.[44] The remaining 98 percent of IRS tax collections resulted from a combination of taxpayer service programs and the *indirect* (*i.e.,* deterrent) effect of IRS enforcement actions. To make budgeting decisions by striving to maximize the 2 percent of collections without grappling adequately with what is required to maximize the remaining 98 percent of collections is a bit like letting the tail wag the dog.

> The conference agreement contains as section 25 a provision similar to that in Section 54 of the Senate amendment. In particular, section 25(a)(2) of the conference agreement more explicitly spells out the condition precedent that Congress first appropriate the base amounts requested for the Internal Revenue Service in the President's Budget for fiscal year 1995 before the provisions of this section apply. Similarly, the conference agreement revises subsection (d), which sets forth the other conditions precedent.

H.R. Conf. Rep. No. 103-490 at 58 (1994).

[44] In FY 2006, IRS enforcement activities (collection actions, examinations, and document matching) resulted in the direct collection of $48.7 billion. Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006). Total tax collection by the IRS, after the issuance of tax refunds, was $2.24 trillion. Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 95 (Nov. 2006).

The Administration's FY 2008 budget request acknowledges this dilemma. It states: "The IRS cannot currently measure either the impact of deterrence or service, but they are positive."[45] In fact, there are no reliable data that show whether the IRS would achieve a greater ROI if it spends additional funds on service or on enforcement. In the absence of such data, one might think the government would err on the side of assisting taxpayers in complying with the law rather than disproportionately ramping up enforcement. If Congress continues to provide the IRS with greater increases for enforcement each year simply because the ROI of direct enforcement can be quantified, the cumulative effect of those increases over time will be to relatively shift the IRS away from taxpayer service and toward tougher enforcement – with no evidence that such a shift will increase revenues and with the possibility that such a shift might decrease revenues.

As former Commissioner Rossotti has written:

> Some critics argue that the IRS should solve its budget problem by reallocating resources from customer support to enforcement. In the IRS, customer support means answering letters, phone calls, and visits from taxpayers who are trying to pay the taxes they owe. Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money.[46]

Because of recent budget pressures and additional service obligations brought about by the late passage of the tax extenders bill and the administration of telephone excise tax refunds, the IRS is actually expecting that it will reduce the percentage of phone calls it answers from the mid-80s to the mid-70s this year, if not lower. The IRS has been working hard on a five-year taxpayer service strategic plan, developed in response to a Senate Appropriations directive in FY 2006. This plan was developed in collaboration with my office and the IRS Oversight Board. It is an excellent product, and it describes well how the IRS can improve its ability to meet taxpayer service needs.

I urge you to keep in mind that taxpayer service provides a positive ROI, and the ROI of taxpayer service may even exceed the ROI of enforcement. The budget rules should be crafted to ensure that the ability to score direct revenue gains resulting from enforcement does not drive results that may be counterproductive. Perhaps the "scorekeepers" could use a blended ROI of taxpayer service and enforcement actions to support a balanced approach to additional IRS funding.

Many aspects of taxpayer service are akin to a wholesale operation that reaches groups of taxpayers (*e.g.,* outreach and education), while IRS audits constitute a far more

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[45] Department of the Treasury, FY 2008 Budget-in-Brief at 56.

[46] Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 285 (2005).

costly retail operation that requires individual taxpayer contact. The IRS should pursue a balanced approach to tax compliance that puts priority emphasis on 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.[47]

3. Congress should provide increases in IRS personnel funding at a steady but gradual pace, perhaps two percent to three percent a year above inflation. We do not think the IRS can ramp up its staffing more quickly without encountering significant transitional difficulties. However, Congress should consider providing more rapid funding increases for technology and research improvements, as the transitional challenges of absorbing additional resources are probably less significant in these areas and the potential exists to generate substantial productivity gains.

In former Commissioner Charles Rossotti's final report to the IRS Oversight Board in 2002, he described the serious total staffing shortages the IRS was facing. He stated that the IRS needed "steady growth in staff in the range of 2 percent per year."[48] The context shows he was discussing real increases (*i.e.,* increases above those required to maintain current services).

At first blush, real annual staff growth of two percent might appear to be an extremely limited request, but the IRS faces significant challenges in adding and training staff. Examination and collection procedures, in particular, are complex, as is the underlying tax law, and experienced personnel must be pulled off revenue-producing priority cases to provide extensive training to new hires. Moreover, new hires generally have lower productivity rates and require significantly closer supervision than experienced employees to ensure they do not take incorrect actions, including actions that impair or violate taxpayer rights.

However, the IRS probably can absorb more rapid funding increases in technology and research, both of which have the potential to increase IRS productivity substantially.

Better technology would allow the IRS to achieve significant efficiencies in a broad range of taxpayer service and enforcement areas. For example, it would allow the IRS to offer taxpayers a wider range of e-filing options to increase the number of taxpayers who file their returns electronically rather than on paper (which would save IRS the cost

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[47] For research purposes, we believe it is important to study inadvertent errors as well as deliberate misreporting. Knowledge about inadvertent errors can be used to clarify ambiguous laws or administrative guidance both to help increase future compliance and to better apply IRS outreach, education, and other voluntary compliance initiatives.

[48] Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 18 (Sept. 2002).

of manually entering data from the roughly 64 million individual income tax returns it received on paper in FY 2005),[49] and it would allow the IRS to expand its document-matching capabilities, which tend to produce high returns on investment because automated processes are relatively inexpensive to operate and maintain.

Better research would allow the IRS to assess the most cost effective ways of meeting taxpayer service needs and to target its limited enforcement resources to maximize its return on investment. We discuss the importance of obtaining more accurate ROI estimates for the IRS's major categories of work under Recommendation #4 below.

In the past, congressional support for additional IRS funding has come in fits and starts. It will not be helpful to provide too much additional funding immediately. It also will not be helpful to provide additional funding for a year or two and then to change direction. To maximize the IRS's ability to do its job, the IRS needs to receive gradual but steady real increases in its total funding every year for at least the next five to ten years.

4. To assist Congress in performing its oversight responsibilities and determining the appropriate IRS funding level in future years, Congress should require the IRS to provide annual or semiannual reports detailing IRS's progress in handling all significant categories of work, including the known workload, the percentage of the known workload the IRS is able to handle and the percentage of the known workload the IRS is not able to handle, the additional resources the IRS would require to perform the additional work, and the likely return-on-investment of performing that work.[50]

In this connection, Congress should consider directing the IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its ROI estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions, including the downstream costs of such work. Improved methods should also be developed to verify, retrospectively, the *marginal* ROI that the IRS has achieved for each category of work.

To provide Congress with meaningful information, the IRS will need to conduct more research to improve the accuracy of its ROI calculations. As we have noted above, direct enforcement revenue constitutes only about two percent of the revenue the IRS collects. Ninety-eight percent of the revenue the IRS collects derives from its taxpayer

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[49] Internal Revenue Service Data Book: 2005, table 3 (showing that the total number of individual income tax returns filed in FY 2005 was 132,844,632) and table 4 (showing that the total number of individual income tax returns filed electronically in FY 2005 was 68,476,328). The total number of individual income tax returns filed on paper in FY 2005 – 64,368,304 – is the difference between these numbers.

[50] Much of this information was published in former Commissioner Rossotti's final report to the IRS Oversight Board. Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002). However, we have not seen updated statistics published in this format since that time.

service programs and the indirect deterrent effect of its enforcement activities. Yet the IRS currently does not have adequate data on which to make accurate estimates of the ROI of its various categories of work, including taxpayer service programs and the indirect effect of its enforcement activities as a whole and broken down by their key components. Developing better data should be made a priority objective. Moreover, ROI estimates should include costs relating to the downstream consequences – such as increased phone calls or correspondence, Appeals conferences, and Taxpayer Advocate Service cases – of the various categories of IRS work.

We acknowledge that developing reasonably accurate modeling is a significant challenge and will require a commitment of resources. Nonetheless, we have recommended in the past and continue to believe that this information will aid the IRS substantially in making resource allocation decisions and will provide Members of Congress with additional information on which to base future funding decisions.[51]

V. Conclusion

The tax gap is a serious problem because it deprives the government of revenue it needs and it creates inequities between compliant taxpayers and noncompliant taxpayers. There is no silver bullet that will eliminate the tax gap. I believe significant progress can be made, however, by following an approach that emphasizes fundamental tax simplification, expanded third-party information reporting, and a more robust IRS compliance program.

The Budget Committee has the jurisdiction to change the existing budget rules that, in my view, have unreasonably constrained IRS funding and limited the agency's ability to maximize tax compliance. I urge the Committee to use its jurisdiction to improve the process by which IRS funding decisions are made.

[51] The congressional budget rules currently prohibit the Congressional Budget Office or the Office of Management and Budget from treating changes in discretionary appropriations to the IRS as giving rise to scorable increases in tax receipts. See H.R. Conf. Rep. No. 101-964 (1990). *See also* Office of Management and Budget, *OMB Circular No. A-11*, Part 8, Appendix A, Principle 14 (2006). Since changes to IRS funding levels undoubtedly have an impact on tax collections, this prohibition seemingly reflects the practical difficulty of devising accurate estimates. Yet accurate estimates obviously would be helpful to Congress, and we believe the IRS should make developing better estimates a priority objective.

VI. Exhibit A: Cash Economy – Administrative Recommendations

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

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

VII. Exhibit B: Cash Economy – Legislative Recommendations

Recommendation		Summary	Reason
1	Amend IRC § 3406 to encourage compliance in certain cash-economy transactions	Amend IRC § 3406 to create a three-pronged reporting and payment system that encourages compliance by: ▪ 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".	Current withholding and information-reporting provisions do not adequately capture income from transactions in the cash economy. Unreported payments include: ▪ 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. 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.
2	Amend IRC § 6302(h) to require IRS to promote estimated tax payments through EFTPS.	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.	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.

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 contactors 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.

VIII. 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.