

**Written Statement of Nina E. Olson  
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**Before the**

**Committee on the Budget  
United States Senate**

**On**

**The Causes of and Solutions to the Federal Tax Gap**

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

Thank you for inviting me to testify today about the causes of the Federal tax gap and proposals to try to reduce it.<sup>1</sup> In my testimony, I will provide an overview of the tax gap and discuss two of its principal causes: (1) the large percentage of taxable payments that are not reported to the IRS and with respect to which the IRS has great difficulty collecting tax (*i.e.*, the “cash economy”) and (2) the difficulty many taxpayers not subject to tax withholding face in saving enough money to pay their tax bills when they come due. I will suggest several possible solutions that eliminate opportunities for noncompliance and thus should reduce the tax gap. These recommendations are outlined in the appendices to this testimony.

The tax gap is composed of many different types of taxes, types of noncompliance, and types of taxpayers. There is no one silver bullet that can eradicate all components of the tax gap, once and for all. This diversity requires the IRS to conduct serious and ongoing research to better understand the causes of the tax gap and to identify the most effective solutions. I commend Commissioner Everson for supporting and expanding the National Research Program (NRP) to help identify the areas where noncompliance is greatest. To help identify the most appropriate and effective solutions, I believe the IRS should also devote more effort to studying the *causes* of noncompliance.

## **I. The Significance of the Tax Gap**

It is widely understood that the failure of some taxpayers to pay their fair share of taxes reduces much-needed Federal revenue. That consequence, by itself, would require the government to act. But the consequences of the tax gap run deeper than that. The tax gap raises an issue of fundamental fairness in the tax system. When honest taxpayers feel like chumps, some of them start fudging, too. And when that happens, voluntary payments drop even more, necessitating more examination and collection actions. This sense that the system is unfair can result in a vicious cycle of increased noncompliance and increased enforcement.

According to preliminary data the IRS released last year as part of the National Research Program (NRP) study of Tax Year 2001 individual income tax returns, the annual gross tax gap falls somewhere in the range of \$312 billion to \$353 billion. After

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<sup>1</sup> 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 authorizing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS or the Treasury Department. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the Commissioner or the Secretary 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.

accounting for receipt of late payments and IRS collection activity, the IRS estimates the annual net tax gap is in the range of \$257 billion to \$298 billion.<sup>2</sup> The IRS estimates tax noncompliance is in the range of 15.0 percent to 16.6 percent. Or, stated differently, the rate of taxpayer compliance with the tax laws in 2001 ranged from 83.4 percent to 85 percent.<sup>3</sup>

The IRS receives approximately 130 million individual income tax returns each year. Given the estimated \$257 billion-\$298 billion net tax gap, the average tax filer pays a “surtax” of some \$2,000 per year to subsidize noncompliance.

## **II. The Cash Economy Is the Largest Source of the Tax Gap**

Where taxable payments are reported to the IRS by third parties, the IRS generally collects well over 90 percent of the tax due. Where taxable payments are not reported to the IRS by third parties, compliance drops precipitously to a range from about 20 percent to about 68 percent, depending on the type of transaction.<sup>4</sup> 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.<sup>5</sup>

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

- About 43 percent of the gross tax gap, \$134 billion to \$155 billion per year, is attributable to underreporting of income and self employment taxes by self-employed individuals.<sup>6</sup>

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<sup>2</sup> The IRS has developed estimates of both the “gross tax gap” and the “net tax gap.” The gross tax gap is the amount of tax that is imposed by law for a given tax year, but is not paid voluntarily and timely. The net tax gap is the portion of the gross tax gap that will not be collected after all IRS and taxpayer actions have been completed for a given tax year. Both figures probably understate the true level of noncompliance because they exclude illegal-source income and certain other categories of noncompliance.

<sup>3</sup> These preliminary results from the National Research Program study were released on March 29, 2005. The IRS plans to update the results shortly, possibly between the time this statement is submitted and the time this hearing takes place.

<sup>4</sup> IRS National Headquarters, Office of Research, July 2004 (unpublished).

<sup>5</sup> 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, 108<sup>th</sup> 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.”).

<sup>6</sup> Taxpayers who underreport business income on individual returns account for \$83 billion to \$99 billion of the gross tax gap and those who underreport self-employment taxes account for another \$51 billion to \$56 billion. IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

- Over 80 percent of all individual underreporting is attributable to understated income rather than overstated deductions.<sup>7</sup>

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.<sup>8</sup>

### **III. To Address the Tax Gap, Congress and the IRS Should Explore Ways to Reduce Opportunities for Noncompliance and Supplement Traditional IRS Enforcement Initiatives in the Cash Economy**

Ninety-nine percent (99%) of income subject to withholding is reported on taxpayers' income tax returns.<sup>9</sup> This fact does not mean that wage earners are "good" people and taxpayers who receive income that is not reported to the IRS by third parties are "bad" people. It means simply that wage earners do not have the opportunity to be noncompliant because their wages are reported by their employers and their taxes are withheld at the source of payment. Participants in the cash economy, on the other hand, have a significantly greater opportunity for noncompliance. An effective strategy for reducing the portion of the tax gap attributable to the cash economy must focus on reducing opportunities for noncompliance.

Moreover, because income from the cash economy is not subject to information reporting, many of the IRS's traditional means of enforcement -- Correspondence Examinations, Document Matching, and Automated Substitute for Returns -- are unlikely to be effective in addressing it. The IRS has a number of initiatives that could be effective if coordinated and pursued more aggressively. However, no single function coordinates research, outreach, and compliance initiatives aimed at improving reporting compliance among cash economy participants. Nor does the IRS give these initiatives the same level of attention as other initiatives, such as those addressing tax shelters or the Earned Income Tax Credit. This lack of coordination and Service-wide attention has historically impaired the IRS's response to the cash economy.

In the National Taxpayer Advocate's 2005 Annual Report to Congress, I recommended that the IRS create a cash economy program office, similar to the Earned Income Tax Credit program office. I am pleased that the IRS Commissioner for the Small Business/Self-Employed Operating Division has agreed to establish a joint IRS-Taxpayer Advocate Service task force on the cash economy that will seek to determine the feasibility of this and other recommendations. I am hopeful that this task force will jump-start the development of a comprehensive strategy for addressing the cash economy that includes education, outreach, research, procedural, and enforcement initiatives.

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<sup>7</sup> IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

<sup>8</sup> 80 percent of \$134 billion (the lower end of the estimate of underreporting attributable to self-employed individuals) comes to \$107 billion.

<sup>9</sup> IRS National Headquarters, Office of Research, July 2004 (unpublished).

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

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. Such a requirement would close much, if not most, of the tax gap. 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 or she takes a cab ride, has someone mow their 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.

For 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 1099-MISC for compensation for services performed or to IRS awareness of this compensation. Thus, we recommend that corporate taxpayers (including Subchapter S corporations) with 50 or fewer shareholders be subject to 1099-MISC reporting requirements to the same extent that unincorporated businesses are today.

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

The absence of a requirement that brokers track and report customers' cost basis in securities has two consequences. First, it often imposes significant compliance burdens

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

But the second consequence of the absence of cost basis reporting is that it affords less honest taxpayers with significant opportunities to overstate their basis and therefore understate their tax liabilities. Reliable estimates of the amount of underreporting in this area are difficult to come by, but two professors have sized the problem at about \$25 billion a year.<sup>10</sup> 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. 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.<sup>11</sup>

#### **V. Many Taxpayers Not Subject to Tax 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.<sup>12</sup> Similarly, the

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<sup>10</sup> Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question*, 106 Tax Notes 453 (Jan. 24, 2005).

<sup>11</sup> Congress could consider providing brokers with a one-time credit to offset the cost of implementing a comprehensive basis-tracking system.

<sup>12</sup> 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

IRS could send letters to self-employed taxpayers each quarter to remind them to make their estimated tax payments. These reminders could point out that taxpayers can use IRS's Electronic Funds Transfer Payment System (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.<sup>13</sup> The letters should also offer to accept estimated payments monthly or even bi-weekly, just like most other recurring bills.<sup>14</sup> Signing up taxpayers for EFTPS could make estimated tax payments almost as automatic as withholding. As previously noted, taxpayers report 99 percent of their income subject to withholding. In the National Taxpayer Advocate's 2005 Annual Report to Congress, I make several administrative and legislative recommendations regarding the electronic payment of estimated taxes.

## **VI. 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 proposed above, actively encouraging self-employed taxpayers to make monthly or even bi-weekly payments toward their estimated taxes through 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.

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indicating that taxpayers would not use credit cards to make estimated tax payments because credit card companies charge a convenience fee. *Id.*

<sup>13</sup> 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 property tax payments or spend the funds elsewhere.

<sup>14</sup> Some mortgage companies offer programs that electronically deduct mortgage payments bi-weekly rather than monthly.

- Amending IRC § 3406 to require a form of “backup withholding” by the payor in cases where a taxpayer-payee has a demonstrated history of noncompliance with the tax laws.

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

In the National Taxpayer Advocate’s 2005 Annual Report to Congress, I recommended that Congress authorize the Secretary to exempt payors from back-up withholding on payments to taxpayers (independent contractors) who present payors with a valid IRS “Compliance Certificate.” A taxpayer would be eligible for a Compliance Certificate if he or she has been in compliance with prior filing and payment obligations. If the taxpayer has been noncompliant, the IRS would still issue a Compliance Certificate if, for example, the taxpayer makes arrangements to satisfy past obligations and schedules a year’s worth of estimated tax payments through EFTPS.

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

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

## **VII. Regulation of Unenrolled Return Preparers Would Reduce Noncompliance in the Cash Economy**

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

taxpayers. Attorneys, certified public accountants, and enrolled agents are all licensed by state or federal authorities, and their right to practice before the IRS is subject to revocation in the event of wrongdoing.<sup>15</sup> Yet there is virtually no federal oversight over “unenrolled” return preparers, who constitute the majority of tax return preparers today.

The IRS does not know how many unenrolled return preparers are actively preparing returns for a fee in the United States. Nor does it know what qualifications and education these preparers possess to prepare returns. While the IRS has a number of initiatives that address the perpetration of criminal schemes by tax preparers, it only conducts a small number of preparer negligence investigations and it collects even fewer dollars in the rare instances that it assesses a preparer negligence penalty.<sup>16</sup>

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

#### **VIII. 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.<sup>17</sup>

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

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<sup>15</sup> Circular 230, § 10.50(a).

<sup>16</sup> 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).

<sup>17</sup> 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.

IRS's local response, and measure its effectiveness. A national cash economy program office could replicate successful local strategies nationwide.

Moreover, the IRS should use more of the information available from state and local governments, Forms 8300 (Report of Cash Payments Over \$10,000 Received In a Trade or Business), and its audit selection tools to audit taxpayers who are operating in the cash economy and underreporting their income. Although the IRS has access to state and local tax information, reporting on large cash transactions, and computer-based tools to identify underreporting, it used very few of these resources in FY 2005.<sup>18</sup>

Many states and localities impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts.<sup>19</sup> 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.

#### **IX. The IRS Needs to Conduct More and Better Research to Identify the Best Approaches to Reducing the Cash Economy Tax Gap and Understanding the Causes of Noncompliance**

The IRS needs research to show the most effective use of its resources after taking into account the direct and indirect effects of its activities on tax revenues.<sup>20</sup> 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.<sup>21</sup>

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<sup>18</sup> 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).

<sup>19</sup> 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).

<sup>20</sup> 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).

<sup>21</sup> 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).

However, not all audits have the same effect on compliance. A dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing corporate tax shelters. A dollar spent on an ineffective audit may actually have a negative effect on compliance if it teaches taxpayers that they will not be caught even if audited. On the other hand, a dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving EFTPS, and answering tax law questions, has a positive indirect effect on compliance.<sup>22</sup> 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.<sup>23</sup> Thus, in the absence of better research, the IRS cannot make fully informed resource-allocation decisions.<sup>24</sup>

It is important to keep in mind that taxpayers are compliant or noncompliant for different reasons, and a comprehensive approach to reducing the tax gap must recognize these differences.<sup>25</sup> Because unreported income from the cash economy is so difficult and costly for the IRS to detect and deter through traditional enforcement methods, the indirect effect of the IRS's activities is even more important in fostering compliance among cash-economy participants than for the general population. Thus, research in this area is very important.

#### **X. While Increasing Its Efforts to Reduce the Tax Gap, the IRS Must Not Decrease Those Services that Enable the Vast Majority of Taxpayers to Comply with the Tax Laws**

As the IRS develops initiatives to narrow the tax gap, it should place priority emphasis on providing sufficient assistance, outreach, and education to those taxpayers who are currently compliant or who are trying to comply so that they do not become

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<sup>22</sup> 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).

<sup>23</sup> 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).

<sup>24</sup> 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).

<sup>25</sup> For a discussion of the categories of taxpayer noncompliance, see Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003).

noncompliant. It should target its formidable enforcement powers at those few taxpayers who will not otherwise comply with the tax laws. If this integrated, two-pronged approach is to succeed, the IRS must fully recognize the central role taxpayer service plays in achieving compliance and do more to study the optimal ways to deliver taxpayer service and the magnitude of the impact.

In discussing the tax gap, we need to be careful that we don't ignore the needs of the vast majority of taxpayers. Taxpayer service plays an important role with respect to the self-employed taxpayer, who may not be able to afford professional tax advice and looks to the IRS for direction. Today, many tax law questions pertaining to self-employed individuals (e.g., self-employed health insurance deduction, depreciation, depreciation recapture on the gain (loss) from the sale or other disposition of business property, net operating losses, and retirement plans) are deemed out-of-scope for IRS employees. If the questions are too complex for IRS employees to answer, then they are likely to be too complex for the small business person. This complexity engenders ill-will toward the IRS and a willingness to fudge. After all, the IRS wasn't there to answer the question.

Thus, in addition to asking ourselves, "How can we reduce the tax gap?" we should ask, "How can we increase voluntary compliance?" This latter question will lessen the tax gap and has the added benefit of focusing on the long-term behavior of taxpayers. Moreover, it makes the IRS analyze programs from the taxpayer's perspective rather than solely from the agency's point of view. Establishing goals for the IRS based on these two questions will ensure that the IRS focuses its activities on the full panoply of taxpayer needs. These goals will require the IRS to design its programs by looking at the underlying causes of noncompliance and applying the appropriate "touch" – education, assistance, procedural change, or enforcement – to bring about maximum compliance with the tax laws.

## 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.

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

<b>Recommendation</b>		<b>Summary</b>	<b>Reason</b>
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.

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

## Exhibit B Cash Economy – Legislative Recommendations

Recommendation	Summary	Reason
1	<p>Amend IRC § 3406 to encourage compliance in certain cash-economy transactions</p>	<p>Amend IRC § 3406 to create a three-pronged reporting and payment system that encourages compliance by:</p> <ul style="list-style-type: none"> <li>▪ Instituting backup withholding on payments to taxpayers who have demonstrated “substantial noncompliance”;</li> <li>▪ 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);</li> <li>▪ Providing that payors will not be required to institute backup withholding on taxpayers who present payors with a valid IRS “Compliance Certificate”.</li> </ul>
2	<p>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>

<b>Recommendation</b>	<b>Summary</b>	<b>Reason</b>
3	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding between independent contractors and service-recipients.	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding between independent contractors and service-recipients (as defined in IRC § 6041A(a)(1)), and to specify that independent contractors who enter into voluntary withholding agreements with payor service recipients will be treated as employees only to the extent specified in the agreements, and allow such independent contractors to continue to deduct ordinary and necessary business expenses under IRC § 162(a).
4	Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations.	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**

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