

**Testimony of Professor Joseph Bankman**  
**Ralph M. Parsons Professor of Law and Business**  
**Stanford Law School**  
**Stanford, CA**  
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The tax gap is a big subject. I'm going to limit my comments to the largest part of the tax gap – that associated with the cash economy. In the interests of time, I'm going to focus on possible (partial) solutions to the problem that the Committee may not have already considered.

My first suggestion is to increase the reach of third-party reporting. Taxpayers who receive income subject to third-party reporting, from wages, dividends or the like, accurately report this income on their tax returns. It is income that is not subject to third-party reporting, such as cash and checks received by sole proprietors, that is the source of most of the tax gap. It is obviously impossible to extend third-party reporting to all transactions. But the current reporting rules are particularly arbitrary and easy to avoid. (To take but one example, payments to individuals and partnerships are subject to third-party reporting, but payments to S Corporations are not.) I've written elsewhere some of the ways these rules could be tightened up, and better enforced. See Bankman, Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs, 2004 TNT 134-43.

Unfortunately, the burden of third-party reporting falls (at least initially) on taxpayers who are not even suspected of evasion. This is a general problem of enforcement in this area and leads to my second suggestion: wherever feasible, reimburse "innocent" taxpayers for their compliance burden. Reimbursement comports with a common sense notion of fairness and will reassure taxpayers that the government is taking their compliance costs into account when setting enforcement policy. For that and other reasons, I believe reimbursement will may be a necessary predicate for some enforcement initiatives. New Zealand has explicitly tied an increase in third-party reporting to a reimbursement plan; we might explore a similar system.

We might also consider reimbursement in connection with audits. Twenty years ago, Congresswomen Nancy Johnson (Connecticut) suggested the government reimburse taxpayers for the cost of the old TCMP "super" audit. It was a good idea then and is still a good idea. I've elsewhere suggested the government extend reimbursement to garden variety audits in which the taxpayer is found to owe little or no tax. See <http://www.law.nyu.edu/colloquia/taxpolicy/042204.pdf> One obvious way to reduce the tax gap is to increase the audit rate and I assume you are already weighing this option. I suspect an increase in audit rates, like other initiatives in this area, would be more popular if tied to an reimbursement system.

My third suggestion is to cross check tax returns with state property tax records. Eventually, income from cash business that is not reported is used – if there is enough of it – to fund property purchases. Some individuals will report virtually no income yet purchase millions of dollars worth of property. Huge discrepancies between property purchases and reported income might be built into the program that sifts out returns for audit. I understand California may develop a pilot program here – the federal government may want to monitor the success of

that program.

My fourth suggestion is to work with the preparer community to more aggressively pursue the (few) bad apples in that community. A small number of dishonest preparers are responsible for a disproportionate amount of evasion. These preparers put honest preparers at a competitive disadvantage and help maintain an equilibrium of low reporting rates in certain segments of the economy.

The most highly publicized component of the tax gap is, of course, that associated with high end tax shelters, rather than the cash economy. The loss from tax shelters may be small compared to the loss from the cash economy but it is absolutely large. I have written on the problem of tax shelters and worked with California to develop legislation in that area. See Bankman, Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs, 2004 TNT 134-43 (and articles cited therein). I'd be happy to discuss tax shelters with members of the Committee but as my time is limited, will not offer any prepared remarks on the subject.