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Testimony Before the Senate Finance Committee

July 21, 2004

Hearing on Bridging the Tax Gap

Introduction

Mr. Chairman, Senator Baucus, and members of the Committee, thank you for the opportunity to testify before the Senate Finance Committee. I am Raymond T. Wagner, Jr. I recently marked my first anniversary as a Member of the IRS Oversight Board.

It's been an exciting year and I have learned a lot about the needs of taxpayers and the IRS. I'm pleased to be able to testify to you today on the subject of the tax gap.

Characteristics of the Tax Gap

Mr. Chairman, the National Taxpayer Advocate reported in her 2003 Report to Congress that the IRS has estimated the gross tax gap for 2001 as approximately $311 billion. This amount is the difference between what taxpayers pay voluntarily and what they are supposed to pay. The IRS also collects approximately $55 billion as a result of late payments and additional enforcement activities, so the net tax gap for 2001 was estimated at about $255 billion.

These numbers sound precise, but they are in fact estimates. The exact size of the tax gap is uncertain. The Commissioner made this point in testimony earlier this year before both the House and Senate Appropriations Committees. Current estimates are based on a model developed under the now-defunct Taxpayer Compliance Measurement Program (TCMP),last used in 1988. The program's model was extended to 2001 based on current demographics, but assumes that taxpayer behavior remains the same.

However, the tax administration system and our economy have markedly changed since 1988, and the nature of these changes provides more opportunities for increased non-compliance. For example:

- The tax code itself has grown increasingly complex during this period.
- In the past several years, we have seen a proliferation of abusive tax shelters coupled with an erosion of ethical standards among tax professionals, including the large-scale selling of abusive schemes by formerly respected members of the accounting and legal professions.

- Surveys conducted by the IRS Oversight Board indicated an erosion of taxpayer attitudes regarding the acceptability of cheating. In 2003, 17 percent of Americans believed it was acceptable to cheat at least a little on their taxes, compared to 11 percent in 1999.
- Economic growth produced large growth in the numbers of high-income taxpayers, increased capital transactions that are more difficult to audit, increased the number of taxpayers claiming tax credits, and spurred the formation of S-Corporations and partnerships, all of which provide more opportunities for non-compliance. The table below illustrates how certain elements of taxpayer reporting have increased between the years of 1990 and 2001.

Changes in Taxpayer Reporting From 1990 to 2001

Taxpayer Attributes (in thousands)	1990 (note 1)	2001 (note 2)	Percent growth
All individual returns	113,717	130,255	15%
Individuals reporting AGI > $100,000	3,165	11,035	249%
Individuals reporting AGI > $1,000,000	61	192	215%
Individuals reporting net capital gain	9,217	12,631	37%
Individuals reporting net capital loss	5,070	10,840	114%
Individuals reporting partnership income	3,210	4,357	36%
Individuals claiming tax credits	12,484	49,793	299%
Number of corporations	3,716	5,035	35%
Number of S-corps	1,575	2,986	90%
Number of partnerships	1,553	2,132	37%

Source: IRS SOI Bulletins
Note 1: The year 1990 was chosen because it is the closest year to 1988 (the last year for TCMP) for which statistics of income information is available.
Note 2: 2001 is the year for which the tax gap is estimated at $311 billion.

The National Research Program (NRP) is a IRS-wide research effort to determine compliance with the tax laws. This information will be used to help the IRS develop compliance measures and estimates of the tax gap, select returns for examination, and identify areas where instructions and pre-filing taxpayer services can be improved. Through the NRP, the IRS will update its research on the tax gap for individual taxpayers. As a consequence of the trends I just described, it would not be surprising if the NRP results show significant growth in the tax gap.

Consequences of the Tax Gap

Mr. Chairman, the tax gap is not just a statistic thrown about by academicians and tax experts. It is far more insidious. We must get behind the tax gap number and examine its corrosive effects upon our entire tax administration system and the fiscal health of the nation. The tax gap's consequences are all too real and we feel them in our everyday lives.

- First, at the most basic level, the tax gap is an injustice. It means that honest taxpayers are bearing the financial burden of those who do not pay what they owe. The men and women who play by the rules – regardless of income bracket – pay more in taxes to make up for those who game the system and cheat. In a very tangible way, we are subsidizing this army of tax scofflaws.

- Second, our nation finds itself, in a time of fiscal constraint with many worthy but competing federal programs, from homeland security to education, chasing after the same scarce budget dollars. We need the extra tax revenues that closing the tax gap would provide.

- Third, and perhaps most troubling, the tax gap undermines confidence in the fairness of our tax administration system and contributes to non-compliance. Honest taxpayers hear and read about growing tax cheating that goes unpunished. Promoters of abusive tax avoidance schemes openly flout the law and dare others to follow their lead. Discouraged by a lack of enforcement, some taxpayers go so far as to wonder if they too should not cheat. Why should they pay if no one else is? As previously noted, the Board's own research points to an erosion of taxpayer attitudes towards cheating.

Recommendations to Reduce the Tax Gap

The tax gap was not created overnight, nor can it be reduced overnight or dealt with in a single year. It can be however, by following a thoughtful, multi-year, strategic plan with persistence, discipline, and skill. Successful execution of the plan involves all participants in the tax administration system—the IRS, the Administration, Congress, taxpayers, and tax professionals. This must be a unified effort.

The plan's strategies are simple in concept but challenging to execute. Some are already underway, but more must be done to bring the desired results. Each strategy reinforces the others, and together form an integrated whole. They are:

1. Increase the effectiveness of the IRS
2. Provide additional resources
3. Measure results
4. Simplify the tax administration system

1. Increase the effectiveness of the IRS

The IRS Oversight Board recently approved the *IRS Strategic Plan 2005-2009*. Its major theme is **Service plus Enforcement Equals Compliance**, which Commissioner Everson will describe in his testimony. The plan's underlying goal is to bring *all* taxpayers into voluntary compliance. Education and service will help taxpayers who make honest mistakes to understand and comply with their tax obligations. At the same time, effective enforcement efforts will be aimed at those who willfully flout the tax laws.

The Board fully endorses that approach, and believes that the plan describes the goals that the IRS must achieve in the next five years:

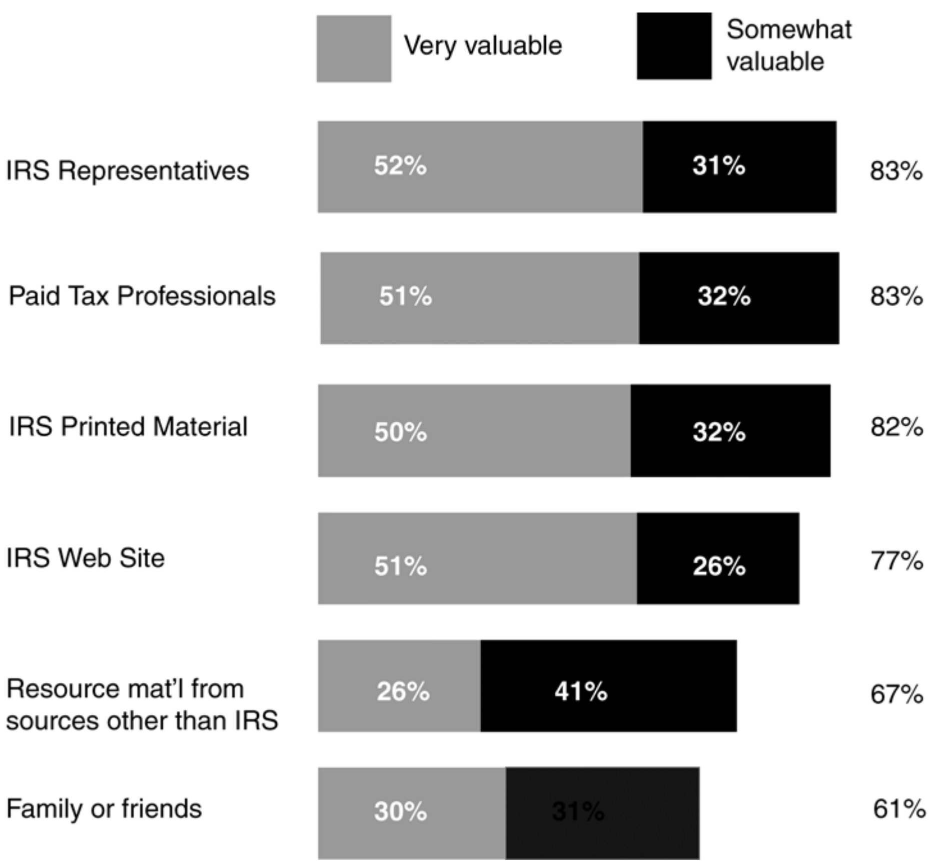
A. Improve Taxpayer Service
B. Enhance Enforcement of the Tax Law
C. Modernize the IRS Through its People, Processes, and Technology

A. *Improve Taxpayer Service*

Taxpayers value the services the IRS provides to help them navigate an incredibly complex tax code and meet their responsibilities under this law. The IRS has made considerable strides in improving customer service during the past five years and these improvements are reflected in taxpayer satisfaction surveys such as the American Customer Satisfaction Index (ASCI). Taxpayers are better able to get through on the agency's toll-free lines and receive correct answers to their tax law and account questions. IRS web site usage continues to surge and new features such as "Where's My Refund?" and "Where's My Advanced Child Tax Credit" have been added. Electronic filing of individual tax returns grew by 15 percent in 2003.

Taxpayers value these services. The 2003 IRS Oversight Board Taxpayer Attitude Survey found that "the most heavily relied upon source of tax information and advice are IRS representatives (83 percent see them as very/somewhat valuable), closely followed by IRS printed publications such as brochures (82 percent) and the IRS web site (77 percent). The only non-IRS-provided information source that is as highly rated is a paid tax professional (83 percent.).

Taxpayers Value IRS Service



Source: IRS Oversight Board Taxpayer Attitude Survey 2003

The Board believes that improved service directly contributes to improved compliance. Mistakes and lack of information can contribute toward non-compliance. And it's no wonder; because the tax code's complexity grows with each passing year. The IRS now estimates that it takes 28 hours and 30 minutes to complete an average tax return versus 7 hours and 7 minutes in 1988.

The IRS must do everything it can to help taxpayers navigate and understand their responsibilities under the code. A failure to meet this pressing need would invite further noncompliance.

The Board finds IRS customer service to be a work in progress still with ample room for improvement in key areas such as telephone tax law accuracy. In this regard, the Board believes that complacency is the worst enemy.

B. Enhance Enforcement

As the tax gap illustrates, enforcement remains a serious challenge for the IRS, and there is no broad turnaround in sight. However, the Board recognizes that some improvements have been made. For example, the IRS has been able to put the brakes on the rising collection backlog. The Treasury Inspector General for Tax Administration (TIGTA) also found that many collection compliance indicators showed improvement in FY2003. Collection re-engineering, which the Board strongly supports, is generating positive benefits, such as a 15 percent increase in the number of Taxpayer Delinquent Accounts closed and a substantial jump in the use of enforcement tools, such as liens, levies and seizures. Other innovative programs are refocusing resources in key areas:

- To pursue promoters of abusive shelters, domestic and offshore abusive tax avoidance transactions (ATAT), high-income taxpayers, and unreported income, the IRS is focusing resources away from traditional examination functions into key strategic areas.
- To improve its initially unsuccessful K-1 matching program, the IRS redesigned forms and related instructions, making them easier to understand, simplified the filing process, and worked closely with stakeholder groups to build understanding and support for the program.
- To crack down on abusive shelters, the IRS has increased its use of promoter audits. The IRS has over 100 such audits in progress, and established a Lead Detection Center to centralize and develop leads on abusive tax avoidance transactions.
- To shorten the cycle time on large corporate audits from five years to two years, the IRS is using a streamlined process to identify issues for audit by focusing on materiality and risk analysis.
- To strengthen its Office of Professional Responsibility, the IRS appointed an experienced director, and proposed tougher penalties on professional misconduct.

Enhancing enforcement is a major IRS goal for the next five years and it is already putting in place an aggressive plan to improve its enforcement efforts. Commissioner Everson has described the IRS' plan in more detail, but key elements of its plan involve deterring abusive tax schemes and behavior that erodes confidence in the tax administration system, ensuring that tax professionals follow the law and adhere to high standards of integrity, deterring criminal activity, and placing greater emphasis on the activities of tax exempt and government entities and their misuse by other taxpayers. This last area is a growing area of abuse and I commend the Finance Committee for its hearing on this subject in June.

C. *Modernize Itself through People, Processes, and Technology*

The Board believes that human capital is the IRS' greatest resource and strength, and one of its greatest challenges. The IRS possesses an extremely talented and dedicated workforce that produces very high-quality work in spite of technological and resource limitations. However, the IRS workforce cannot be taken for granted. It must be carefully selected, trained, and given the skills and tools it needs to meet the demands of tax administration in the 21st Century, including new and greater enforcement challenges. The IRS must develop an agency-wide human capital strategic plan that keys in on five areas:

1. **Replace lost critical talent** – The IRS has a "graying" workforce with 25 percent eligible to retire by 2006. Many of these individuals possess critical skills, such as maintaining legacy IT systems, and institutional knowledge of enforcement that could easily be lost.
2. **Build skills for complex work** – Tax administration will become more complex in the future as demonstrated by the challenges in combating abusive tax avoidance transactions that are increasingly more sophisticated and harder to detect. Enhanced IT skills will become more important in this new environment, such as the use of technology as the preferred means of doing business.
3. **Manage change** – Even though the IRS customer-focused organization is firmly in place, change will continue throughout the agency. The IRS is no longer a static organization; new technology and process redesign will bring further challenges and greater change, and with it, an increased demand for leaders and managers with change management skills and experience.
4. **Enhance performance** – Given budgetary constraints, the IRS must enhance its performance each year to meet greater work demand and improved customer service and enforcement goals. Management skills take on greater importance in such a high performance, goal-driven environment.
5. **Engage the entire workforce** – Workforce engagement remains a challenge. Surveys indicate that upper management levels of the IRS are engaged in its mission and strategic goals; but the same cannot be said for front-line managers and rank-and-file employees. This is particularly troubling for front-line enforcement personnel.

Getting the right people with the right skills into the right jobs is but one part of the equation when it comes to providing quality customer service and improved enforcement. To balance it, we must give them the technology to do their jobs effectively and efficiently.

The IRS is modernizing its processes and technology through the Business Systems Modernization (BSM) Program. This program has experienced serious schedule delays and cost overruns, and in December 2003, the Oversight Board released an independent analysis of this program in which the Board made nine specific recommendations for turning around the critical but troubled program.

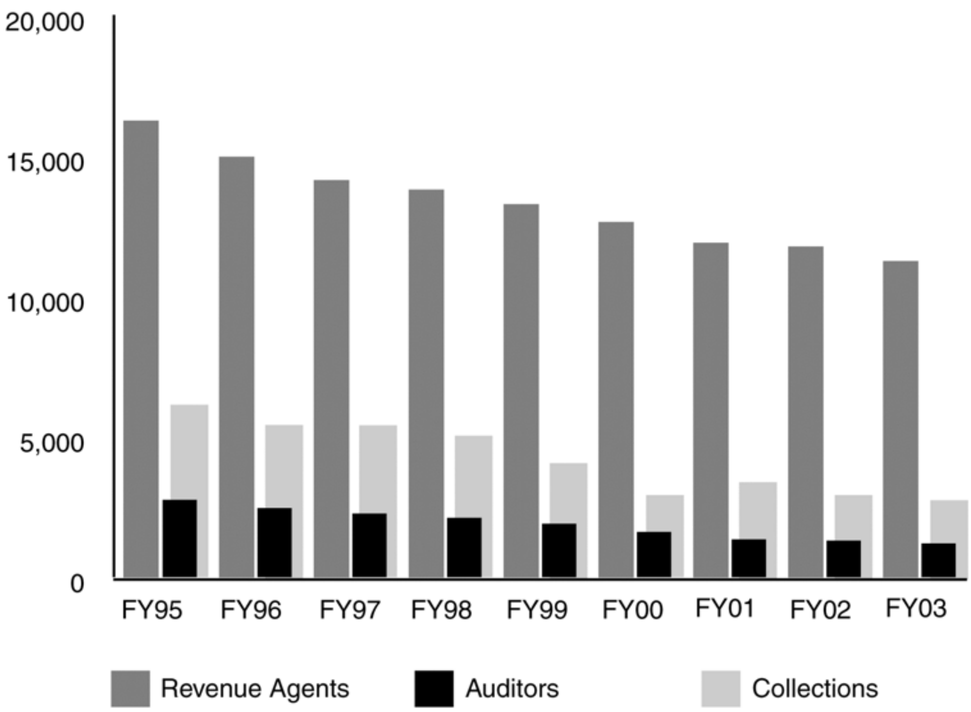
However, the Board still believes that the overall Modernization plan is sound and well-designed. Moreover, it is critical to the future of tax administration and reducing the tax gap. The IRS Oversight Board firmly believes that the IRS Modernization program cannot be allowed to fail. The IRS cannot continue to operate with the outmoded and inefficient systems and processes it uses today. Over time, the existing systems will become impossible to maintain and at that point, the ability to administer our country's tax system will be in grave danger. Such a risk to our nation is unacceptable. We remain convinced that the overall Modernization plan is sound and well-designed. The challenge is executing that plan.

2. Provide additional resources

One important strategy for closing the tax gap is combating egregious noncompliance. In the past two years, the IRS sharpened its compliance focus on promoters and participants of abusive tax shelters and tax evasion schemes. The Board supports this focus–but the job cannot be done unless adequate resources are available for the IRS to fight back.

Enforcement activities are still at an unacceptable level simply because the IRS does not have the resources needed to accomplish its mission. The agency continues to be outmanned and outgunned. In FY2003, the IRS was able to pursue only 18 percent of known cases of abusive devices designed to hide income, leaving an estimated $447 million uncollected. Meanwhile, TIGTA notes that the combined Collection and Examination function enforcement staffing declined from 25,000 at the beginning of FY1996 to 16,000 at the end of FY2003, a 36 percent decline. This staffing shortfall has produced startling consequences.

Number of Examination and Collection Staff Stagnant



Source: Treasury Inspector General Tax Administration (TIGTA) Analysis

According to former IRS Commissioner Charles O. Rossotti in his "Report to the IRS Oversight Board: Assessment of the IRS and the Tax system," released in September 2002, fewer resources means that:

- 60 percent of identified tax debts are not pursued
- 75 percent of taxpayers who do not file a tax return are not pursued
- 79 percent of identified taxpayers who use abusive devices (e.g., offshore accounts and abusive tax shelters) to evade tax are not pursued
- 56 percent of identified taxpayers with incomes of $100,000 or more and underreported tax are not pursued
- 78 percent of partnerships and similar document matching are not pursued.

The table below illustrates the extent to which several categories of enforcement workload the IRS can and cannot accomplish and the resulting revenue loss per year.

Known IRS Workload Gap

	Known Workload in Contacts or Cases/Yr				**Direct Revenue Loss Per Year**	**Direct Cost to Fill Gap**	
	Required	**Done**	**Gap**	**%Gap**		**FTEs**	**Dollars**
Collection of Known Tax Debts							
► Field and Phone Accounts Receivable (TDA)	4,506,060	1,816,713	2,689,347	60%	$9,470	5,450	$296.4
Identification and Collection of Taxes from Non-Filers							
► Non-Filer Cases (TDI)	2,490,749	625,025	1,865,724	75%	$1,693	2,016	$101.5
Collection of Underreported Tax							
► Document Matching	13,300,000	2,926,980	10,373,020	78%	$6,960	4,740	$229.2
Identification and Collection of Underreported Tax							
► Cases of Abusive Devices to Hide Income	82,100	17,000	65,100	79%	$447	3,418	$272.1
► Individuals Over $100,000 Income	123,006	54,468	68,538	56%	$266	2,603	$207.2
► Individuals Under $100,000 Income	843,380	296,986	546,394	65%	$4,492	7,435	$430.1
► Small Corporations	39,659	29,721	9,938	25%	$54	640	$50.9
► Mid and Large Corporations	24,523	17,684	6,839	28%	$6,526	1,812	$180.0
Total	1,112,668	415,859	696,809	63%	$11,786	15,908	$1,140.3
Tax Exempt							
► Reporting Compliance	20,690	6,780	13,910	67%	NA	1,192	$101.6
Grand Total	NA	NA	NA	NA	$29,909	34,664	$2,180

Source: Commissioner Rossotti, Assessment of the IRS and the Tax System, End of Term Report to IRS Oversight Board, Sept. 2002

The IRS Oversight Board finds the IRS' inability to keep up with a growing workload to be a dangerous weakness in the tax administration system. Mr. Chairman, the Board acknowledges that the IRS's budget has increased in each year of President Bush's Administration, and that the Administration's request for FY2005 is significant against other non-defense, non-homeland security discretionary funding. That commitment is commendable, and the Board recognizes and thanks President Bush and Secretary Snow for their efforts, especially at a time when the nation must balance many important and competing priorities.

However, the Board believes that now is a critical time for our tax system to be strengthened, not merely maintained at current levels.

In its special report on the IRS FY2005 budget, the Board addressed this issue head-on by reinvesting in the IRS to produce tangible benefits and results for America's taxpayers and our nation. The Board calls for a pragmatic budget that reflects the complex world in which the IRS must operate and be funded.

The Board recommends IRS funding of $11.204 billion for FY2005, which is a 10 percent increase from FY2004, with a significant increase of 3,315 full-time equivalents (FTEs) to boost enforcement efforts. If enacted, the Board's budget would increase our nation's revenue by approximately $5 billion each year once the IRS has hired and trained additional enforcement personnel.

Under the Board's budget, the IRS would have the additional resources to:

- Close over an additional 1,000 cases involving high risk/high-income taxpayers and promoters who avoid paying income taxes by using offshore credit cards and abusive trusts and shelters.
- Boost audit rates by 42 percent from FY2004 to examine companies that use aggressive tax avoidance tactics, such as offshore transactions and flow-through entities.
- Contact an additional 200,000 taxpayers who fail to file or pay taxes due; a 40 percent boost from FY2004 and a 27 percent increase from the Administration's request. This alone will allow the IRS to collect $84 million more in revenue owed than the Administration's request would allow.
- Sustain the one-on-one assistance that millions of Americans rely on at tax time. The Board's budget will ensure that the IRS will be able to maintain its improved service to taxpayers by answering eight out of ten phone calls.

By comparison, the Board believes the Administration's FY2005 budget cannot achieve its stated goal to add almost 2,000 personnel to bolster the IRS' enforcement efforts, and will threaten hard-earned improvements in customer service. This year's request will lead to a $230 million shortfall in the IRS budget because it fails to budget adequately for an anticipated $130 million of congressionally-mandated civilian pay raises, rent increases, and at least $100 million of unfunded expenses.

In its FY2005 budget recommendation, the Board anticipates a 3.5 percent pay raise for civilian employees, which achieves parity with the Administration's call for a 3.5 percent military pay raise. The Administration, by contrast, calls for a 1.5 percent civilian pay raise. The Board believes that the 1.5 percent civilian pay increase fails to recognize recent history. FY2005 will likely be the fourth year in a row in which the Administration has called for IRS staff increases, while not covering pay raises or required expenses.

The Board was established to bring to bear its collective expertise and familiarity with private sector best practices on the IRS' problems. To the private-life Board members, investments in enforcement pay for themselves many times over, not only in revenue dollars but by the deterrence value of reinforcing the belief that all taxpayers are paying their fair share. A strong business case can be made for providing the IRS with several hundred million dollars so it can collect billions in revenue. Closing the tax gap is imperative. At a time when federal revenue as a percentage of the economy has shrunk to 1950s levels and we face a $500 billion deficit, the Board believes that we must strengthen our tax collection system.

For that reason, the Board recommends that both Congress and the Administration reevaluate their methodology by including the revenue value to the country when estimating budget requests for the IRS. Indeed, considering the positive impact of additional resources provides a better framework for making informed decisions and will lead to a more effective IRS.

3. Measure results

Mr. Chairman, reducing the tax gap requires a firm grasp and understanding of current levels of voluntary compliance. As previously noted, the data we now have is old and unreliable. However, beginning in 2005, the NRP will provide for the first time in more that 15 years solid estimates of voluntary compliance for the various segments of the U.S. taxpayer population. But the NRP is more than numbers and raw statistics.

Reducing the current unacceptable levels of non-compliance requires that we better understand the factors that drives voluntary compliance and non-compliance. That too is an important part of NRP's mission – finding out what makes taxpayers meet their obligations of their own accord. In other words, we have to know what is working and what is not in both customer service and enforcement. Based on this data, management can then make informed decisions that can boost levels of compliance and help close the tax gap.

The IRS is no stranger to measures. Under former Commissioner Rossotti's leadership, the agency effectively deployed and used measures to help improve customer service in key areas such as service on its toll-free telephone lines. These so-called "end result" and "outcome" measures not only tracked progress but helped the IRS establish higher goals for improving its service to taxpayers.

However, the lack of reliable voluntary compliance data has hampered the IRS' ability to effectively use outcome measures for enforcement. The IRS has been forced into the position where it must use interim measures such as the audit rate to track compliance. This is a reasonable approach with the data available, but unsatisfactory in the long term. By their very limited nature, interim measures cannot gauge the impact of education and outreach, practitioner oversight and audit rates on voluntary compliance or how to best utilize resources to achieve the most favorable outcome. The NRP will turn around this situation.

The NRP data will provide the IRS with information on the individual voluntary compliance rate. And just as importantly, it will provide an accurate baseline from which the IRS can begin to set long-term goals for the tax system compliance activities discussed in this testimony. This is a positive step and the Board cannot stress enough the importance of this data and the establishment of a long-term compliance goals. However, this is only the beginning. The IRS must also understand the voluntary compliance rates for businesses, corporations and the tax-exempt entities and what drives voluntary compliance for these taxpayers.

Mr. Chairman, as I mentioned earlier in my testimony; measures are more than sheer numbers. Establishing long-term goals can be very powerful in energizing an organization. Take for example, the long-term goal established for e-filing. Although the 80 percent target was directed specifically at the IRS, it required the shared commitment of the IRS, the practitioner community, software developers and other partners to work towards achieving it. And while the goal may not be reached by 2007, its impact is undeniable. It energized the participants in the tax system to work together in an effort to achieve success.

Long-term goals for compliance can similarly energize the IRS and participants in the tax system to work together to close the tax gap. Recently, Senator Baucus proposed that the IRS raise voluntary taxpayer compliance to 90 percent by 2010. While I agree that we should set the bar high, I caution against establishing a value for the goal without knowing where voluntary compliance is today. Here again, the NRP can provide some valuable assistance.

In addition, the voluntary compliance goal should be embraced by all in the tax system and should not rest solely on the IRS' shoulders. We are all in this together and to improve voluntary compliance takes the effort and commitment of taxpayers, the IRS, practitioners, the legal community, the Administration, Congress, the business community and tax advisors. We all have a stake in improving the well-being of the tax system. And we need the right measures and outcome goals to achieve that measure of success.

4. Simplify the tax administration system

The IRS Oversight Board is precluded by law from addressing tax policy issues, but it would be remiss not to address the cost of our nation's complex tax system; a cost ultimately borne by taxpayers and the IRS.

The costly, confusing, and debilitating complexity of the tax code directly feed the tax gap. The National Commission on Restructuring the IRS, of which the Chair was a member, said the following on complexity of the tax code:

> *The Commission found a clear connection between the complexity of the Internal Revenue Code and the difficulty of tax law administration and taxpayer frustration. . . . The Commission found that significant noncompliance—both inadvertent and intentional—results from various obstacles within the current system, including the cost of compliance and the complexity of the tax law.*

A particularly troublesome complexity looming on the horizon is the Alternative Minimum Tax, as it threatens to ensnare more taxpayers in succeeding years. In her annual report, IRS National Taxpayer Advocate Nina Olson recommended repeal of the AMT, saying:

> *The AMT is extremely and unnecessarily complex and results in inconsistent and unintended impact on taxpayers.…[T]he AMT is bad policy, and its repeal would simplify the Internal Revenue Code, provide more uniform treatment for all taxpayers, and eliminate the oddity of dual tax systems. AMT repeal would also allow the IRS to realign compliance resources to facilitate more efficient overall administration of the tax code.*

The Board fully concurs with her assessment, and urges the Administration and Congress to consider accepting this recommendation in future legislation.

However, while it cannot and will not recommend specific legislative remedies to address the cost and burden of tax complexity borne by all of us, the Board believes that most efforts to simplify the tax code simply tinker at the edges. For that reason, the Board believes that by solving the fundamental problems at the heart of a complex tax code requires fundamental reform. The Board strongly encourages that Congress and the Administration explore ways to simplify our tax code. The potential for the benefits could be enormous for our society and our economy.

Conclusion

Mr. Chairman, in conclusion, I want to thank the Committee for holding this valuable hearing and shedding some important light on the nation's tax gap. The tax gap is an affront to all honest taxpayers and saps our nation of precious resources when it needs them most. The tax gap is an enormous problem that has been mounting for years. However, the IRS Oversight Board believes that in time, it can be solved through the four-pronged approach I have outlined today. Given the right tools and resources, the IRS is up to the task at hand. But it cannot go it alone. The ultimate success in closing the tax gap rests in all of our hands and in our shared commitment and dedication to the integrity and viability of our tax administration system. Thank you and I would be happy to answer your questions