

HEARING BEFORE THE U.S. SENATE

COMMITTEE ON FINANCE



July 21, 2004

Washington, DC

**Pamela J. Gardiner
Acting Inspector General
Treasury Inspector General for Tax Administration**

Chairman Grassley, Ranking Member Baucus, and distinguished Members of the Committee, I appreciate the opportunity to appear before you today to discuss the tax gap problem, what the Internal Revenue Service (IRS) is doing to address it, and additional actions that could be taken.

The Composition of the Tax Gap

In the past, the prevailing view was that the tax gap was primarily composed of unreported and delinquent taxes from the “underground economy.” For example, self-employed contractors such as painters, housekeepers, and plumbers were suspected of failing to report and pay taxes on the cash payments they received. In addition, illegal activities, such as drug trafficking, were thought to be making large contributions to the tax gap.

However, it has recently become apparent that in addition to the problems with tax reporting and payment in those areas, there has been an ever-increasing problem with compliance both domestically and abroad. Reports of corporate corruption also point to a far greater tax gap problem than was originally suspected.

In recent years, the legal and accounting professions have also been identified as contributing to the overall tax gap problem by promoting illegal or questionable tax avoidance schemes. Increasing the bottom line has outweighed ethics and professional responsibility in far too many cases. Additionally, the increased globalization of our economy provides opportunities for corporations and individuals to avoid taxes using tools available in the worldwide marketplace. Offshore credit card schemes are just one example of a tool to hide taxable income in an offshore bank account.

These recent increases in participation in tax avoidance schemes and the promotion of them by highly-respected firms has evidently fueled a more cavalier attitude toward the tax system among the general population. Survey results recently released by the IRS Oversight Board indicated that from 1999 to 2003, the percentage of people who believe it is acceptable to cheat on their taxes grew from 11 percent to 17 percent, and almost one-third of young people age 18 to 24 were likely to feel that any amount of cheating on taxes was acceptable. This is an alarming trend. However, the survey also indicated that 95 percent of people believed it was “somewhat important” or “very important” for the IRS to ensure compliance by corporations and high-income individuals.

The Tax Gap—How Big Is It?

No one really knows the true size of the tax gap. In past years, the IRS used the Taxpayer Compliance Measurement Program (TCMP) to measure compliance levels among individual taxpayers and identify potential tax law changes to address the tax gap. However, the TCMP was discontinued in the late 1980’s

due to concerns about its intrusiveness. The IRS has undertaken efforts to replace the TCMP with an initiative designed to measure compliance of both individuals and businesses. This initiative is called the National Research Program (NRP). However, the NRP has experienced delays, and initial data to update the individual tax return selection formulas will not be available until January 2006.

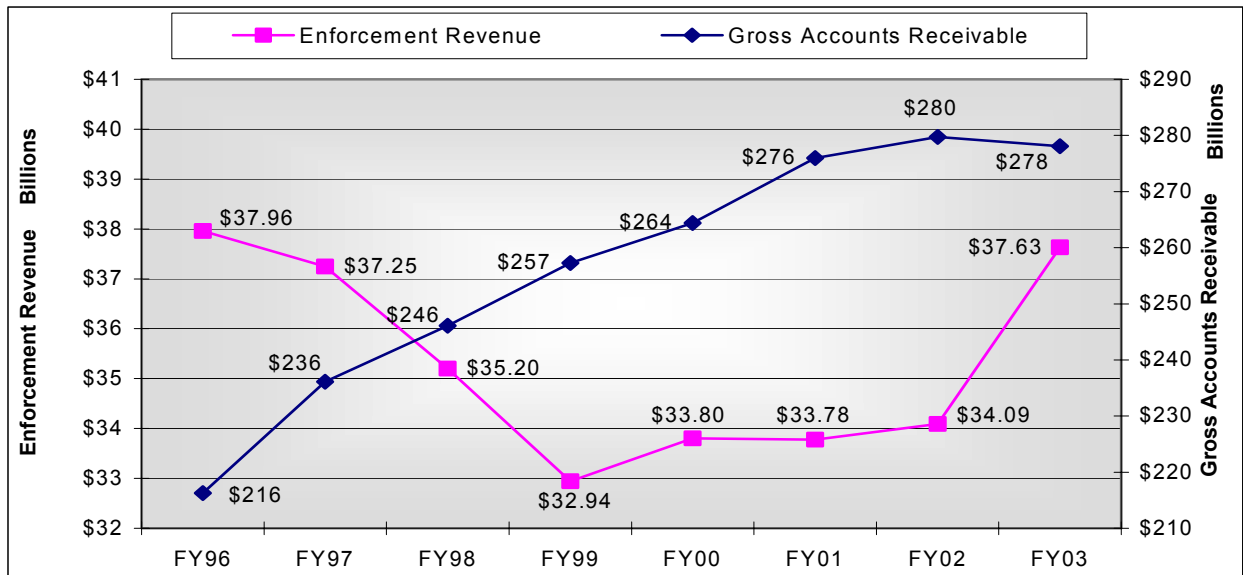
In the late 1990's, the IRS shifted its focus from enforcing tax compliance to improving customer service. This resulted in improvements in the customer service area, but enforcement actions were significantly reduced, and staffing levels in the enforcement areas decreased substantially.

As a result, the IRS estimates the annual gross tax gap (total tax liability for a given tax year less tax paid voluntarily and timely) increased from \$282.5 billion in Tax Year (TY) 1998 to \$310.6 billion in TY 2001. Subtracting late tax payments from that figure results in a net tax gap increase from \$232.5 billion to \$255.2 billion.

What Is the IRS Doing to Address the Tax Gap?

The IRS is making some progress in addressing certain components of the tax gap. For example, as the following chart shows, in Fiscal Year (FY) 2003, enforcement revenue collected increased by 10 percent after remaining fairly constant during the prior 3 years, and there were more collection actions in FY 2003 than in FY 2002. Additionally, after steadily rising for 6 years, the amount of gross accounts receivable was reduced slightly (by \$1.67 billion) from FY 2002 to FY 2003. The IRS is taking a number of actions to improve its ability to react more quickly to an actual or potential tax debt. These actions include shortening the collection notice cycle and migrating toward a risk-based approach to collecting delinquent taxes.

Amounts of Enforcement Revenue Collected Compared to Growth in Gross Accounts Receivable



Source: IRS Enforcement Revenue Information System and Chief Financial Officer Financial Reports

Another objective of the IRS is to discourage and deter noncompliance within tax-exempt and government entities and the misuse of such entities by third-parties for tax avoidance. Examinations are currently underway of tax-exempt credit counseling organizations and abusive tax avoidance transactions involving tax-exempt organizations.

As part of its efforts to combat tax shelters, the IRS is expanding its partnership with state tax agencies to pursue abusive tax transactions and address other criminal activity. As of early June, the IRS Commissioner reported the IRS has shared 28,000 leads with states, and the IRS and states have uncovered tens of millions of dollars in previously unidentified abusive transactions during the early stages of this partnership effort. In addition, the IRS Commissioner has recently more than doubled the size and clarified the mandate of the Office of Professional Responsibility to help ensure attorneys, accountants, and tax practitioners abide by the standards and laws that apply to their professions.

Example of Tax Shelter Efforts - Combating Offshore Schemes

The IRS has begun addressing taxpayers' attempts to avoid taxes through the use of offshore techniques. Congressional witnesses have estimated that 1 to 2 million taxpayers avoid \$40 to \$70 billion in taxes annually using offshore bank accounts. The IRS developed the Offshore Credit Card Project (OCCP) to address this problem and made it a strategic priority for FYs 2003-2004. The OCCP uses information from the

transactions of credit cards issued from offshore banks to identify taxpayers evading taxes and the promoters of this type of scheme.

IRS results as of March 31, 2004, for this Project have been mixed. Although nearly \$5 million in additional assessments¹ have been made on approximately 300 cases, the direct examiner cost associated with these cases is almost \$1.5 million. This cost does not include the intensive labor costs associated with initiating these cases. In addition, the vast majority of the more than 3,000 completed cases have been closed without an assessment of any additional taxes.

Another IRS Project, called the Offshore Voluntary Compliance Initiative (OVCI), grew out of the OCCP and provided an opportunity for users of offshore accounts to come forward and pay back taxes, interest, and certain penalties but avoid fraud penalties or criminal prosecution. This initiative ran from January 14 to April 15, 2003.² The OVCI reflected attempts to bring taxpayers back into compliance quickly while simultaneously gathering more information about the promoters of these offshore schemes. As part of the request to participate in the OVCI, applicants were required to provide full details on those who promoted or solicited the offshore financial arrangement.

IRS results for the OVCI were more encouraging than those from the OCCP. In February 2004, the IRS reported this initiative had yielded over \$170 million in taxes, interest, and penalties to the United States Treasury. The data the Treasury Inspector General for Tax Administration (TIGTA) reviewed indicated that the direct examiner costs associated with this project were only around \$220,000. However, the data showed that even though the applicants voluntarily provided the tax information, over half of the completed cases had been closed without additional assessments.

What More Can Be Done To Address the Tax Gap?

Improving voluntary compliance rates is critical to the health of America's tax system. While the IRS is taking actions to address the tax gap and has a strategy focused on reducing it, the data models that this strategy is based on are over 15 years old. As a result, the IRS cannot be sure it is deploying its critical compliance resources to most effectively address the tax avoidance schemes that have arisen since these models were developed. Updated and reliable compliance data are critical to ensuring effective compliance planning and deployment of resources, as well as to providing justification to support legislative proposals designed to assist the IRS in addressing the tax gap.

¹ This figure includes tax assessments only—associated penalty and interest assessments were not included.

² The deadline to come forward was April 15, 2003. However, there are still open OVCI cases in Examination's current inventory.

In recent years, TIGTA has made various recommendations to enhance the IRS' ability to identify nonfilers and assist in obtaining tax returns and payments. These recommendations address various components of the tax gap and could supplement the IRS' overall strategy to address it.

Withholding on Non-employee Compensation

One solution TIGTA believes would have a serious and quantifiable impact on compliance among the self-employed would be a legislative provision to mandate withholding on non-employee compensation payments, such as those provided to independent contractors. TIGTA has made recommendations to the IRS that it initiate a proposal for a legislative change in this area in two separate reports. The IRS has agreed to consider such a proposal. The Taxpayer Advocate has also recommended this step in her 2003 Annual Report issued to the Congress.

Research indicates that in 1998, 64 percent of the income tax gap and 40 percent of the employment tax gap was attributable to self-employed individuals. Later analyses indicate that these percentages have been growing. Because noncompliance in the self-employed population remains a significant component of the tax gap, TIGTA maintains that implementing a provision in this area could reduce the tax gap by billions of dollars.

In addition to implementing withholding on non-employee compensation, other actions should be taken to improve compliance among independent contractors. For example, improvement is needed to address inaccurate reporting of Taxpayer Identification Numbers (TIN) for independent contractors. For TYs 1995 through 1998, the IRS received about 9.6 million statements for Recipients of Miscellaneous Income (Forms 1099-MISC), reporting approximately \$204 billion in non-employee compensation that either did not contain a TIN or had a TIN that did not match IRS records. This problem could be addressed by mandating that the payer and payee verify the TIN at the beginning of their relationship, but legislation would again be required.

Improving Compliance With Estimated Tax Payments

Estimated tax is the method used by individual taxpayers to pay taxes on non-wage income on a quarterly basis. About 12 million taxpayers made estimated tax payments totaling \$183 billion for TY 2001. However, there is significant taxpayer noncompliance with estimated tax requirements. For each tax year from 1995 through 2000, between 5.7 million and 6.8 million individual taxpayers were assessed penalties for making

insufficient or late estimated tax payments. Many of these taxpayers also filed tax returns reporting unpaid taxes that resulted in the IRS having to take costly collection actions.

Revisions to the way the penalty is computed, legislative changes to require monthly payments, increases in the promotion of electronic payments, and issuance of a reminder notice to taxpayers who have paid estimated taxes in the past, could improve the compliance rate of these taxpayers.

Matching Documents to Verify Business Income

TIGTA has also identified improvements that should be implemented to improve compliance in business tax filing. For example, although individual wage earners that receive a Wage and Tax Statement (Form W-2) have their wages verified through a matching program, a similar comprehensive matching program for business documents received by the IRS does not exist.

The Government Accountability Office³ recently reported that more than 60 percent of U.S.-controlled corporations and more than 70 percent of foreign-controlled corporations did not report tax liabilities from 1996 through 2000. Implementing a comprehensive matching program to identify noncompliance among businesses would be difficult and could require some legislative changes, but it could identify significant pockets of noncompliance within the business tax universe.

Addressing Compliance in the Global Marketplace

Compliance among partnerships with foreign partners is another area that needs to be addressed. For example, the law requires that partnerships withhold taxes on certain income allocable to foreign partners. Tax is withheld on each foreign partner's distributive share of the income. Further action is needed to ensure that this withholding occurs and is accurate, and that refunds are only issued when the withholding is present.

Increasing the Examination Rate

Various studies have confirmed the connection between higher examination rates and better rates of voluntary compliance, even beyond that of those individuals examined. One study issued in 1990 projected that the indirect effects of examinations produced \$6 out of every \$7 in additional revenue. Another more recent study projected that doubling

³ Formerly known as the General Accounting Office.

the examination rate would increase assessments and collections by \$16.7 billion.

Although individual examination rates increased from FY 2000 to FY 2003, the vast majority of that increase is due to increases in correspondence examinations, which are likely to be much less effective in improving voluntary compliance of the general population than face-to-face examinations. The number of examinations of all corporate tax returns continuously decreased from FY 1997 to FY 2003, decreasing a total of 67 percent during that time period. In FY 1997, 1 out of 52 corporate returns filed was examined, and in FY 2003, 1 out of every 182 was examined.

Increasing Staffing in the Enforcement Functions

As stated earlier, staffing in the IRS' compliance areas has decreased significantly in the last few years. The Collection and Examination functions' combined enforcement staff declined from 25,000 at the beginning of FY 1996 to 16,000 at the end of FY 2003, a 36 percent decrease. In the Criminal Investigation (CI) function, Special Agent staffing at the end of FY 2003 was lower than in 3 of the last 4 years, and hiring efforts are struggling to keep pace with attrition. Staffing issues will become even more critical, as 45 percent of the currently employed Revenue Agents and Revenue Officers are eligible for retirement in the next 5 years.

The Administration's budget proposal for FY 2005 includes increased staffing for compliance functions, and the IRS Commissioner has indicated that some of the increase would be allocated to corporate compliance. Allocating training funds to less experienced employees will also be critical as highly-experienced employees retire from their positions.

Ensuring Individuals Sentenced for Tax Crimes Comply With Their Sentences

A recent outside study showed the activities of the IRS' CI function have a strong measurable impact on voluntary compliance. However, in 18 of 26 cases TIGTA reviewed in a recent audit, convicted criminals did not comply with the conditional terms that were imposed as part of the sentence. In 12 of those cases, the IRS did not notify the probation officers or the courts of this noncompliance. The IRS is taking action to improve the procedures in this area, and TIGTA believes that ensuring these actions are effective will send a clear message to the general public on the importance of complying with the tax laws.

In closing, I would like to reiterate the IRS has numerous significant efforts underway to address the various components of the tax gap. It is particularly critical that the IRS continue to obtain updated data from the NRP to enable it to revise the compliance data models, make more accurate forecasts of the extent of noncompliance, and ensure it uses its limited compliance resources in the most effective manner. TIGTA has recommended more actions which, if taken, could assist the IRS in its efforts. Finally, as has been stated numerous times, the complexity of the tax code affects both the compliance of the general population and the ability of the IRS to identify and take action on noncompliance.