IRS Oversight Board

WRITTEN TESTIMONY OF

IRS OVERSIGHT BOARD CHAIRMAN
RAYMOND T. WAGNER, JR
BEFORE
THE SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
ON
A CLOSER LOOK AT THE SIZE AND SOURCES OF THE TAX GAP

JULY 26, 2006

Introduction

Mr. Chairman, Ranking Member Jeffords, and members of the Subcommittee, I am Raymond T. Wagner, Jr., Chairman of the IRS Oversight Board. Thank you for the opportunity to testify today on the tax gap.

The IRS Oversight Board, by statute, is responsible to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws. Our job is to provide strategic governance over the IRS and ensure that the organization and operation of the IRS allows it to carry out its mission.

Despite significant improvements in IRS operations in the last six years, the tax gap, because of its size and persistence, is one of the most serious problems facing tax administrators in this country today.

You have many witnesses here today who are expert in the causes and composition of the tax gap. I would like to focus my testimony primarily on its consequences and what the Board thinks can be done to reduce it.

Background

The tax gap is defined as the difference between the amount of tax imposed on taxpayers for a given year and the amount that taxpayers pay voluntarily and timely. The IRS' latest estimate of the gross tax gap, as presented to the Senate Budget Committee in February 2006, is $345 billion annually, based on 2001 tax returns. In 2005, IRS enforcement activity resulted in $47.3 in enforcement revenue, leaving a net tax gap of approximately $298 million.

The tax gap can be divided into three types of non-compliance: not filing required returns on time; not reporting one's full tax liability even when the return is filed on time; and not paying by the due date the full amount of tax reported on a timely return, with separate tax gap estimates for each type of noncompliance. Underreporting is estimated to be nearly 82 percent of the gross tax gap; non-filing is 8.6 percent, and underpayment is 9.6 percent of the gross tax gap.

The tax gap is caused by taxpayer non-compliance, and one major source of non-compliance is the complexity and confusing state of the tax code. The noncompliance rate associated with the annual gross tax gap is 16.3 percent. Our tax administration system starts with the expectation that taxpayers will comply voluntarily with the tax laws. However, the reality is that some taxpayers do not do so, and the IRS expends considerable effort identifying those taxpayers and taking enforcement actions. However, only a fraction of what is owed is recovered through enforcement.

The smaller the gross tax gap, the more taxpayers are complying voluntarily, and the more efficient and effective the tax administration system is. However, I would caution the committee that it is not realistic to achieve 100 percent voluntary compliance.

I would also caution the committee that the tax gap is only an estimate that the IRS develops through its National Research Program (NRP), based on analyzing a sample of tax returns. In April 2006 the Treasury Inspector General for Tax Administration (TIGTA) reported that, despite the significant efforts undertaken in conducting the individual taxpayer NRP, the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and the voluntary compliance rate of many types of entities, including corporations.

Consequences of the Tax Gap

Mr. Chairman, although these statistics can be mind-numbing, they represent real numbers that represent a serious problem in our tax administration system. The tax gap can have 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 taxpayers 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, honest taxpayers are subsidizing those who evade their taxes.
- Second, it deprives our government of revenue to which it is entitled.
- Third, and perhaps most troubling, the tax gap undermines confidence in the fairness of our tax administration system and contributes to non-compliance.

Recommendations to Reduce the Tax Gap

The tax gap is not a new problem and many of the organizations represented on this panel have previously made recommendations on how to reduce it. However, the problem is a difficult one and continues to persist.

The Board has evaluated the recommendations made by various members of the tax administration community for reducing the tax gap, drawn upon that material as well as its own evaluation, and in April 2006 included in its report to Congress on the IRS' FY2007 budget a set of recommendations for reducing the tax gap.

The Board found a great deal of consistency and commonality among the recommendations made by organizations concerned with reducing the tax gap, and concluded that there is no one "silver bullet" that can be implemented that will solve the problem. Rather, the Board believes that reducing the tax gap requires a comprehensive set of strategies with action on many fronts—

from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

I will preface the Board's recommendations with a few overarching remarks to help the Committee place the various recommendations into a broad context.

The reporting and payment of taxes by individuals and corporations is a process that begins with a self-assessment made by the taxpayer of taxes owed. The taxpayer's self-assessment will be correct and complete to the extent that the taxpayer is fully knowledgeable of his or her obligations, motivated to report honestly, and has the resources to pay what is owed. Once the return is filed, the IRS can apply resources to evaluate whether the taxpayer has fully met his or her obligations and require the taxpayer to pay any additional amounts necessary to be fully compliant.

The Board believes that a successful set of strategies to reduce the tax gap must be focused on both prevention as well as correction. Broad strategies are needed that will cause taxpayers to file more compliant tax returns in addition to strategies that seek to improve IRS' enforcement programs. In the words of Ben Franklin, "an ounce of prevention is worth a pound of cure."

In this regard, effective strategies are needed that influence taxpayers to file and pay what they owe voluntarily. It may be tempting to direct the IRS to correct the problem through more enforcement, but this approach should be complemented by other efforts that stress prevention. However, comprehensive preventative solutions such as simplifying the tax code and evaluating new information reporting requirements require concerted action from the executive and legislative branches working together, and hence are more difficult to implement, but getting real results will require this type of concerted action.

The need for additional resources also should be considered. A successful strategic approach needs to be more thoughtful and comprehensive than merely increasing IRS resources and expecting that the gap will shrink. That being said, however, increased IRS resources should not be discounted as a valid part of the solution. A successful set of strategies will encompass several separate but interrelated approaches that will reinforce each other to produce the desired result.

The Board recommends six inter-related strategies that it believes would constitute an over-arching plan to reduce the tax gap. Many of these recommendations will serve to prevent non-compliance as well as aid correction, or enforcement, efforts. I expect that many of the other witnesses will recommend similar ideas.

The first recommendation is to simplify the tax code. Our complex and ever-changing tax code not only confounds honest taxpayers who want to comply with their obligations under the law, but provides ample opportunity for those who exploit its complexity to cheat. The President's Advisory Panel on Federal Tax Reform observed:

> Since the last major reform effort in 1986, there have been more than 14,000 changes to the tax code, many adding special provisions and targeted tax benefits, some of which expire after only a few years. These myriad changes decrease the stability, consistency, and transparency of our current tax system while making it drastically more complicated, unfair, and economically wasteful. Today, our tax system falls well short of the

> expectations of Americans that revenues needed for government should be raised in a manner that is simple, efficient, and fair.[1]

Second, the Oversight Board recommends improved information reporting and enforcement tools to address large areas of the tax gap related to what has been called the cash economy. Although the Board is prohibited by statute from endorsing any specific proposal, we note that in its FY2007 budget submission, the Administration makes several legislative recommendations to close the tax gap that include: (1) increasing information reporting on payment card transactions; and (2) expanding information reporting to certain payments made by federal, state and local governments to procure property and services. They certainly merit congressional discussion and consideration.

The National Taxpayer Advocate also recommended in her 2005 Annual Report to Congress that the IRS create a cash economy program office, similar to the Earned Income Tax Credit program office. The Board is pleased that the IRS Small Business/Self-Employed Operating Division Commissioner has agreed to establish a task force on the cash economy that will seek to determine the feasibility of this and other recommendations.

In testimony before the Senate Budget Committee, the National Taxpayer Advocate further recommended that 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."[2] The Board supports such analysis. GAO has also made recommendations for legislative action that provide the IRS with better enforcement tools.[3]

In short, there is no shortage of ideas for tax code simplification and improved enforcement tools. Both require legislative actions and are clear examples of solutions that require coordinated action by the legislative and executive branches. As more taxpayers are potentially affected by the Alternative Minimum Tax, the case for simplification will increase even more. The Board urges the Finance Committee and Congress to move forward in both areas.

Third, the Board believes that the IRS must improve customer service, including education and outreach, to make taxpayers aware of their legal obligations and ease taxpayer burden through modernization. Indeed, not all non-compliance is willful; a significant amount is due to the complexity of the tax laws that results in errors. IRS Commissioner Everson recently testified:

> [T]he tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, though, at this point, we do not have sufficiently good data to help us know how much arises from willfulness as opposed to innocent mistakes. This is an area where we expect future research to improve our understanding.[4]

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[1] Statement by the Members of the President's Advisory Panel on Federal Tax Reform, "America Needs a Better Tax System", April 13, 2005

[2] National Taxpayer Advocate, "Testimony Before the Senate Budget Committee, Causes and Solutions to the Federal Tax Gap", February 15, 2006.

[3] Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions, GAO Report GAO-06-453T dated February 15, 2006

[4] IRS Commissioner Mark Everson, Testimony Before the Senate Budget Committee, February 15, 2006.

The National Taxpayer Advocate has also suggested that the IRS could make it easier for taxpayers to pay their tax bills. She has suggested that the IRS should make it just as easy for taxpayers to make their estimated tax payments as it is to pay other bills. Many private sector 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. Services such as these are likely to increase taxpayer compliance to the extent they can help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make tax payments.

Improvements in customer service and enforcement can be facilitated through increased IRS resources. To give the IRS additional resources for enforcement and service, and help it to better leverage technology, the Oversight Board recommended additional investments in the FY2007 budget in the following areas:

- Taxpayer service, $43.6 million
- Enforcement, $367.8 million
- Infrastructure and management, $104.7 million
- Business Systems Modernization, $188.6 million

Fourth, there should be a much greater emphasis and focus on research so the IRS can more effectively target areas of major non-compliance. The Board recommends that the IRS develop a long-range strategic plan for research that goes beyond the current 2009 end date for the IRS Strategic Plan. In such a plan, the IRS should describe how it will bring its research on all taxpayer segments up to date, and perform a limited sample every year so that its research on all segments will be as current as possible.

The Board believes the availability of up-to-date research data will allow the IRS to more effectively focus its service and enforcement programs on areas that have the greatest impact on taxpayer compliance, and use the changes in taxpayer compliance rates as feedback to evaluate the effectiveness of IRS' service and enforcement program on actual taxpayer compliance. Achieving such a capability will be a vast improvement over the current situation in which the lack of data makes it virtually impossible to evaluate the effectiveness of IRS activity on taxpayer compliance and make informed decisions. Both GAO and TIGTA, in their testimony to the Senate Appropriations Committee this year, supported the Board's recommendation on compliance research.

The Board also recommends that the IRS conduct research on the impact of customer service on voluntary compliance and the service needs of taxpayers. The need for such research is also consistent with recommendations made by Treasury Inspector General for Tax Administration and the National Taxpayer Advocate in testimony last year to the Senate Appropriations Committee on the closing of a number of Taxpayer Assistance Centers.

The availability of up-to-date research on taxpayer compliance will aid the IRS in implementing measures to evaluate its progress in reducing the tax gap. Without a reliable way of measuring the compliance more quickly, it will be difficult to measure progress to reduce the gap. Up to date research on non-compliance also helps the IRS to more effectively attack abusive tax evasion schemes.

The Board commends the IRS for adding a voluntary compliance goal for 2009 in its FY2007 Congressional Budget Justification, but an effective NRP must be in place to measure the progress in achieving this goal.

Fifth, the Board urges a more productive partnership between IRS and the tax administration community. At the Board's 2006 public meeting, the American Institute of Certified Public Accountants supported the IRS' efforts to partner with professional organizations in the area of pro bono tax assistance, noting that such a synergy provides the IRS with the opportunity to leverage precious resources and increase customer service at the same time. The Board would add that such a partnership also contributes directly to compliance.

Tax practitioners prepare over 60 percent of individual tax returns, and have a great deal of influence on taxpayer compliance levels. Although practitioners have professional obligations to represent their clients effectively, they also have an important role in ensuring that taxpayers are complying with their legal tax obligations. The Senate Finance Committee conducted a hearing on April 4, 2006 to examine the state of professional tax preparation services available to the public, and found some troubling results. More attention is needed on this area to ensure that professional tax preparers are knowledgably and ethically assisting their clients to comply with the tax laws.

Sixth, there must be more emphasis on personal integrity in making tax decisions. The Board has found that the vast majority of taxpayers state that their personal integrity is a very important factor in influencing their tax compliance. In the Board's most recent Taxpayer Attitude Survey, 82 percent of taxpayers cite personal integrity as the principal factor for reporting and paying their taxes honestly. Board surveys since 2001 have consistently showed that the public says that personal integrity is much more important than fear of an audit or information reporting in influencing them to report and pay their taxes honestly. Commissioner Everson also testified at the Senate Budget Committee tax gap hearing:

> [A]nother enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures.[5]

Our tax administration system should challenge taxpayers and preparers to be conscious of the need for integrity when making tax decisions, and maintain the highest standards of compliance.

Summary

The Oversight Board recognizes that no single initiative or program will solve the tax gap — a multi-faceted effort must be taken to shrink it. The plan must be more comprehensive than just applying additional resources to do more of what is being done today.

Implementing an effective plan will be difficult, and involves taking broad action across the legislative and executive branches of government. However, the potential results are worth the effort.

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[5] Everson, *op.cit*.