Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance

U.S. Department of the Treasury

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I. Introduction

The Internal Revenue Service (IRS) collects 96 percent of the government's total receipts, approximately $2.7 trillion in FY 2008. The vast majority of those revenues come from taxpayers who voluntarily report and pay the taxes that they owe. The IRS has estimated the overall voluntary compliance rate to be approximately 84 percent.

Despite the voluntary compliance rate and vigorous enforcement by the IRS, a significant amount of revenue remains unreported and unpaid. In 2005, the IRS estimated this gross tax gap to be approximately $345 billion. After subtracting revenue obtained through enforcement actions and other late payments, the IRS estimated the net tax gap to be approximately $290 billion. These estimates, which remain the most recent estimates available, were conducted using data collected in tax year 2001 and before.

As a result of an increase in funding included in the IRS FY 2009 budget, the Department of the Treasury (Treasury) and the IRS have recently initiated intensive efforts to update the estimate of the tax gap on an ongoing basis, which will permit more regular and effective assessments. Consistent with its commitment to long-term fiscal soundness, the Administration is committed to working closely with Congress to narrow the tax gap, which imposes an unfair burden on every American who pays taxes in full. Ongoing updates of the tax gap estimate starting in 2011 will form the basis for regularly assessing progress towards that goal.

Building on reports previously released, this report is intended to provide a comprehensive overview of efforts to close the tax gap. This report is also intended to serve as a baseline for further work and discussion. After briefly discussing the nature and scope of the tax gap, this report summarizes previous Treasury and IRS tax gap reports and identifies the areas of strategic priority detailed in those reports. This report then summarizes the achievements, ongoing efforts, and new initiatives for achieving progress in each of those areas of strategic priority, organized according to the components of the strategy to reduce the tax gap detailed in prior reports.

As this report will make clear, the IRS and Treasury, working with Congress, are pursuing a wide range of initiatives, including a series of legislative proposals included in the Administration's FY 2010 budget. The Administration recognizes the particular value of those efforts and initiatives that improve voluntary compliance by making the tax filing process easier and more taxpayer-friendly. While aggressive enforcement activity can also help to narrow the tax gap, it is important to recognize that increased enforcement efforts require certain trade-offs. The Administration is committed to working closely with Congress to strike an appropriate balance to maximize revenue collection without imposing unreasonable compliance and enforcement burdens on the vast majority of individuals and businesses that fully and willingly pay what they owe.

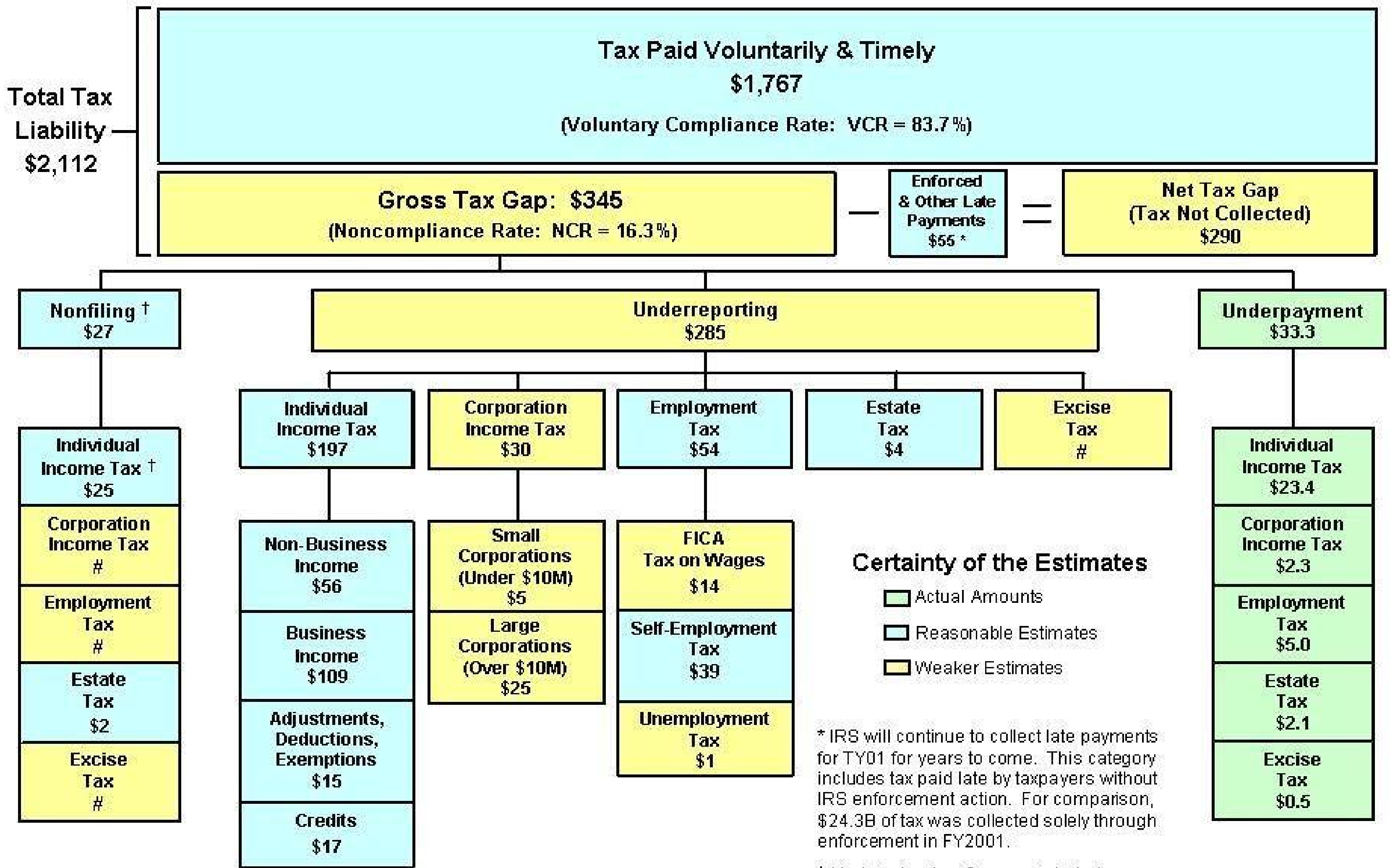
II. The Tax Gap

The Tax Gap Map that follows illustrates the nature and scope of the tax gap based on data from 2001 and prior years. As this map shows, noncompliance takes three forms:

- Underreporting (not reporting one's full tax liability on a timely-filed return);
- Underpayment (not timely paying the full amount of tax reported on a timely-filed return); and
- Nonfiling (not filing required returns on time and not paying the full amount of tax that should have been shown on the required return).

The IRS has separate tax gap estimates for each of these three types of noncompliance. Underreporting (in the form of unreported receipts and overstated expenses) constitutes over 82 percent of the gross tax gap. The single largest sub-component of underreporting involves the individual income tax, which represents more than 50 percent of the total tax gap. Underpayment constitutes nearly 10 percent, and nonfiling almost 8 percent of the gross tax gap.

TAX GAP MAP for Tax Year 2001 *(in $ Billions)*



* IRS will continue to collect late payments for TY01 for years to come. This category includes tax paid late by taxpayers without IRS enforcement action. For comparison, $24.3B of tax was collected solely through enforcement in FY2001.

† Updated using Census tabulations

No estimates available

IRS • Research, Analysis, and Statistics

III. Prior Tax Gap Reports

In September 2006, Treasury's Office of Tax Policy issued a Comprehensive Strategy for Reducing the Tax Gap.[1] The 2006 report provided a primer on the components and measures of the tax gap and a seven-component strategy for reducing the tax gap. The components of that strategy are:

1. Reduce Opportunities for Evasion
2. Make a Multi-Year Commitment to Research
3. Continue Improvements in Information Technology
4. Improve Compliance Activities
5. Enhance Taxpayer Service
6. Reform and Simplify the Tax Law
7. Coordinate with Partners and Stakeholders

Following on this report, the Internal Revenue Service in August 2007 issued a more detailed report on Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance.[2] Emphasizing the same seven components outlined above, the 2007 report outlined specific projects and initiatives, legislative proposals, and other actions designed to attack the sources of noncompliance in each area. Four key principles guided the development of the strategy and continue to guide Treasury and IRS efforts to improve compliance:

- First, both unintentional taxpayer errors and intentional taxpayer evasion should be addressed.
- Second, sources of noncompliance should be targeted with specificity.
- Third, enforcement activities should be combined with a commitment to taxpayer service.
- Fourth, policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

The 2007 tax gap report also provided a detailed explanation of the composition of the tax gap. That explanation is reproduced in full in the appendix of this report.

IV. Update on Efforts to Reduce the Federal Tax Gap: Progress on Strategic Components

The prior tax gap reports detailed a seven-component strategy to reduce the tax gap and discussed and proposed specific actions to be taken within each component. This section of the

[1] "Comprehensive Strategy for Reducing the Tax Gap," U.S. Department of the Treasury, Office of Tax Policy, September 26, 2006.
[2] "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," Internal Revenue Service, Department of the Treasury, August 2, 2007.

report provides an update on those efforts, including a discussion of new proposals. The following section discusses the current IRS Strategic Plan, issued subsequent to the 2007 tax gap report, which covers FY 2009-2013, and outlines five long-term measures for evaluating the IRS' progress in achieving its goals, which directly relate to the tax gap strategy.

<u>Component 1: Reduce Opportunities for Evasion</u>

Implement and Expand Information Reporting Authorities

Previous reports have outlined the relationship between voluntary compliance and the degree to which income tax return items are "visible" to the IRS. Reporting compliance is highest where parties other than the taxpayer are required to file information reports and withhold taxes from payments made.

From the taxpayer's perspective, information reporting can lead to significant administrative simplification. Most Americans receive W-2 forms at the end of each year, which reduces the taxpayer's burden by eliminating the need to gather records or perform computations. W-2 recipients with no other major source of income can simply transcribe information from the W-2 form directly onto the tax return. For those taxpayers who e-file, the process is simplified even further, as the data from the W-2 can be electronically imported. At the same time, W-2 forms facilitate the ability of the IRS to detect non-compliance.

To improve compliance and minimize error, Treasury and IRS have been focused on implementing several new information reporting regimes recently authorized by Congress.

- **Credit and debit card payments to businesses**. Starting in January 2011, organizations that process credit and debit card payments for merchants must annually report the amount of these payments to the recipient businesses and to the IRS. Treasury and IRS are actively working on the implementing regulations and soliciting input and feedback from taxpayers, banks, and credit card processors.
- **Cost basis reporting.** Starting in January 2011, brokerage firms must annually report cost basis and holding period information to customers and to the IRS in addition to gross proceeds from securities transactions. These information reports will make it easier for taxpayers to compute the net amount of gain or loss and will have a significant effect on reducing misreported capital gains.

In addition, the Administration's budget for FY 2010 includes the following significant new information reporting proposals:

- **Payments to Corporations**. The FY 2010 budget proposals would require businesses to file information returns for payments to a corporation for any services (such as accounting services or consultancy services) or certain gains aggregating to $600 or more per year. This would end current practice under a longstanding regulatory regime that exempts certain payments to corporations from general requirements for information reporting. These information reports will serve as reminders to the corporate recipients to include these amounts in gross receipts and will make these amounts visible to the IRS for targeted compliance programs.

- **Rental Property Expense Payments**. The FY 2010 budget proposals would require taxpayers who receive rental income and deduct expenses on rental activities to file information returns for rental property expense payments to any service provider or contractor that performs work on rental properties. This would make the reporting requirements for taxpayers engaged in rental real estate activities consistent with the requirements for other business taxpayers.
- **Certain Government Payments for Property and Services**. Some government vendors fail to meet their tax filing and payment obligations, and compliance would likely increase significantly if those payments were automatically reported by the governmental entity making the payment. The FY 2010 budget proposals would therefore require Federal, state, and local governments to report information on non-wage payments made for the procurement of property or services. Exceptions are anticipated for certain categories of payments and recipients.
- **Private Separate Accounts of Life Insurance Companies**. The proposals would require life insurance companies to report account information for any contracts invested in a private separate account. The reporting of this information would help the IRS determine whether earnings on investments in separate accounts are taxable income to the holder or are tax-free or tax-deferred.
- **Requiring Certified Taxpayer Identification Numbers (TINs) from Contractors**. Without accurate taxpayer identifying information, the effectiveness of information reporting requirements is limited. Therefore, the FY 2010 budget proposal would require contractors to provide TINs to the businesses from which they receive payments, and require those businesses to verify the TINs. If a contractor failed to furnish an accurate certified TIN, the business paying the contractor would be required to withhold.
- **Increased Penalties for Failure to Properly Report Information.** Penalties for failure to properly report information have not been increased since they were first established in 1989. Increasing those penalties will provide a stronger incentive for compliance with information reporting requirements. Accordingly, the FY 2010 budget proposal would increase by 100 percent the current per-return penalties for failure to file most information returns and would substantially increase the maximum penalties that can be assessed in a calendar year. In addition, the proposal calls for adjusting the penalty amounts for inflation every five years.

Additional Fiscal Year 2010 Budget Proposals

In addition to the information reporting proposals outlined above, the Administration's FY 2010 budget proposes an expansive set of additional tools or requirements to reduce opportunities for evasion and other non-compliance.

Improving compliance by businesses:

- **E-filing by Certain Large Organizations**. Mandate electronic filing for all corporations and partnerships required to file Schedule M-3 (Net Income or Loss Reconciliation). Expand the current regulatory authority to require e-filing by other large organizations (such as certain large exempt organizations). This would provide tax return information in a more uniform electronic form, enhancing the ability of the IRS to focus more productively its audit activities.

- **Clarification of Liability for Federal Employment Taxes of Employee Leasing Companies and Their Clients.** Set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes under certain circumstances. Providing standards for when an employee leasing company and its clients will be held liable for Federal employment taxes will facilitate the assessment, payment, and collection of those taxes.

Strengthening Tax Administration:

- **Assessment of Criminal Restitution as Tax.** Allow the IRS and Treasury to immediately assess, without issuing a statutory notice of deficiency, and collect as a tax debt court-ordered restitution in criminal tax cases. Since court-ordered restitution in criminal tax cases currently cannot be assessed as a tax, the IRS cannot use its existing assessment systems to collect and enforce the restitution obligations. This leads to unnecessary duplication of effort, delay, and confusion.

- **Offer-In-Compromise Application Rules**. Eliminate the current-law requirement that an initial offer-in-compromise include a nonrefundable payment of a portion of the taxpayer's offer. Eliminating this requirement would expand access to the offer-in-compromise program and thereby improve IRS' ability to collect the portion of a tax liability that the taxpayer can pay.

- **IRS Access to Information in the National Directory of New Hires (NDNH).** Expand IRS access to the NDNH for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, and preparation of substitute returns for non-compliant taxpayers. Access to the NDNH would increase IRS productivity by reducing the amount of IRS resources dedicated to obtaining and processing data without reducing the current levels of taxpayer privacy.

- **Repeated Willful Failure to File a Tax Return.** Create an aggravated failure-to-file criminal penalty for any person who willfully fails to file tax returns in any three years of five consecutive years if the aggregated tax liability is at least $50,000. Such failure to file would be classified as a felony with a penalty of a fine of not more than $250,000 ($500,000 for a corporation) or imprisonment of not more than five years, or both. These increased criminal penalties would help deter multiple willful failure-to-file tax returns.

- **Tax Compliance with Local Jurisdictions**. Treat Indian Tribal Governments (ITGs) that impose alcohol, tobacco, or fuel excise or income or wage taxes as States for purposes of information sharing to the extent necessary for ITG tax administration. Treating ITGs as States for information sharing purposes would allow greater sharing of information between the Federal government and ITGs and thereby support Federal and ITG compliance activities.

- **Statute of Limitations where State Tax Adjustment Affects Federal Tax Liability.** Create an additional exception to the general three-year statute of limitations for assessment of Federal tax liability resulting from adjustments to State or local tax liability. The statute of limitations would be extended only for items related to the State tax adjustment. The proposal would remove the current statute of limitations as a barrier to the effective use by the IRS of state and local tax adjustment reports when the reports are provided by the state or local revenue agency to the IRS with little time remaining to make assessments at the Federal level.

- **Investigative Disclosure**. Clarify that the taxpayer privacy laws do not prohibit Treasury and IRS officers and employees from identifying themselves, their organization, and the nature and subject of an investigation when contacting third parties in connection with a civil or criminal tax investigation. This clarification would facilitate investigations by IRS officers and employees while setting forth clear guidance for taxpayers.
- **Electronic Filing by Tax Return Preparers**. Permit regulations to require electronic filing by tax return preparers who file more than 100 tax returns in a calendar year. Electronic filing benefits taxpayers and the IRS because it decreases processing errors, expedites processing and payment of tax refunds, and allows the IRS to efficiently maintain up-to-date taxpayer records.

Expand Penalties

- **Bad Check Penalty.** Clarify, expand, and update the bad check penalty to cover all commercially acceptable instruments of payment, including electronic checks and other payment forms. At present, only checks and money orders are covered by the bad check penalty.
- **Penalties for Failure to Comply with Electronic Filing Requirements**. Establish a penalty for failure to comply with electronic filing requirements of $25,000 for a corporation or $5,000 for a tax-exempt organization. This penalty would not supersede existing penalties for failure to file in any format. Although there are additions to tax for the failure to file returns under current law, there is no specific penalty in the Internal Revenue Code for failure to comply with a requirement to file electronically.

Administration's Proposals and Efforts to Combat Under-Reporting of Offshore Income

The President has made addressing under-reporting of income earned or held through offshore accounts or entities a top priority for his Administration. The Administration has developed a comprehensive approach to combating offshore tax evasion by U.S. taxpayers that includes legislative proposals, efforts to increase exchange of tax information with other countries, and increased enforcement.

Legislative Proposals

The Administration's budget for FY 2010 provides various legislative proposals to address offshore tax evasion, including:

- Reforming the existing IRS "Qualified Intermediary" (QI) program to require additional information reporting from QIs so that the IRS will receive the same level of information on U.S. taxpayers from QI participants that it does from U.S. financial institutions.

- Requiring withholding of tax, in appropriate circumstances, on payments made through intermediaries that are not QIs. This measure would discourage U.S. and foreign persons from attempting to avoid U.S. tax by providing incorrect self-certification to intermediaries or otherwise relying on the lack of information reporting required from foreign intermediaries that are not QIs.
- Denying the benefits of reduced withholding tax rates to certain foreign entities unless the entities identify their owners. This measure would help ensure that persons that are not entitled to an exemption from withholding tax or a reduced rate of withholding tax do not arrange to receive payments through entities that appear to qualify for such an exemption or reduced rate.
- Requiring taxpayers and financial institutions to report to the IRS on cross-border transfers of certain assets.
- Allowing the IRS to make certain legal presumptions to minimize the effect of nondisclosure on IRS investigations and enforcement proceedings when U.S. taxpayers fail to fully disclose their offshore accounts.
- Extending the statute of limitations and imposing increased penalties when certain required information returns are not filed.

Exchanging Tax Information with Other Countries

Access to information from other countries is critically important to combating offshore tax evasion. For this reason, the United States has been a leader in increasing information exchange in tax matters. We have worked through the Organisation for Economic Co-operation and Development (OECD) to establish standards on transparency and exchange of information for tax purposes, and have strongly encouraged countries to adopt these standards. The United States has been more active in broadening the scope of information that countries agree to exchange through tax treaties and in negotiating and implementing tax information exchange agreements (TIEAs).

The United States will continue to update existing tax treaties with insufficient exchange of information provisions. Treasury recently concluded negotiation of updated tax treaty information exchange provisions with two key countries, Luxembourg and Switzerland, and will work toward swift ratification and implementation of those new agreements. Treasury will also continue to enter into new TIEAs, such as the agreements that the United States recently signed with Liechtenstein and Gibraltar.

The United States also will begin expanding its focus with respect to exchange of tax information from advocating international adoption of OECD standards to assessing international implementation of the standards adopted. Consistent with recommendations made by the United States, the G-20 London Summit Declaration called on appropriate bodies to conduct and strengthen objective peer review processes. Accordingly, Treasury will work to establish a robust peer review process to assess implementation of the OECD standards through an expanded version of the OECD-organized Global Forum on Transparency and Exchange of Tax Information, which currently includes OECD members and more than 40 other jurisdictions. Peer review should act to improve international implementation of tax information exchange and thereby help to ensure that such exchange helps to support U.S. taxation of income earned or held through offshore accounts or entities.

Increasing Enforcement

Finally, the President's FY 2010 budget also includes strong support for international enforcement. With the FY 2010 initiative funding, the IRS would hire nearly 800 additional employees dedicated to addressing a broad range of international tax enforcement concerns. The initiative will increase examinations of complex international structures, cross-border transactions, and offshore activity on both corporate and individual returns. The Administration's continued support of IRS enforcement is described in greater detail below.

Status Update
The following chart provides a status update on the full range of initiatives underway to reduce opportunities for evasion. In addition to the new initiatives detailed above, this chart catalogues the progress of initiatives previously reported in the 2006 and 2007 tax gap reports.

Action Items	**Status**
Work with Congress to enact legislative proposals included in the Administration's FY 2010 Budget	In process
Implement recently enacted tax gap legislative proposals	Cost basis and merchant card reporting implementation: • Issued announcement in January 2009 enabling merchant card and third party settlement organizations to begin TIN validation • Issued two notices in February 2009 requesting public comments on the two reporting requirements • Developing new forms, business requirements, compliance programs, and IT solutions • Preparing proposed regulations and draft forms for public comment in Summer 2009 • Participating in ongoing meetings with stakeholders to work through implementation issues Other proposals already implemented: • Revised collection due process for employment taxes • Increased preparer penalties • Implemented erroneous refund claim penalties

Develop regulations and other published guidance clarifying ambiguous areas of the law, targeting specific areas of noncompliance and preventing abusive behavior	Our goal is to release 85 percent of the items appearing on the 2008-2009 priority guidance plan by 9/30/09. Examples include rules in the following areas: • International restructurings • Repatriation of foreign earnings • Transfer pricing and cost sharing • Foreign tax credit generator transactions • Intermediary tax shelters • Withholding tax application to business income earned by foreign partners in US partnerships • Application of the excise tax on reinsurance of US risks by foreign insurers not in business in the US • Corporate "inversions" • Preparer penalties • Welfare benefit funds • Transactions of interest that involve charitable remainder trusts and controlled foreign corporations • By 8/30/09, will release the priority guidance plan for 2009-2010

<u>Component 2: Make a Multi-Year Commitment to Research</u>

Measuring the Tax Gap
In 2005, the IRS released preliminary results of a major research effort to quantify the tax gap using data from tax year 2001 and before. The IRS in following years arrived at the estimate of the gross tax gap of $345 billion for tax year 2001. An update of the tax gap estimate based on more recent data is needed, and the IRS is working on delivering such an estimate in 2011. Updated estimates will help the IRS measure progress against its existing long-term goal of an 86 percent voluntary compliance rate for Tax Year 2009.[3]

To ensure that the Administration and Congress alike have access to more useful, up-to-date estimates of the tax gap, the Treasury and the IRS have begun to implement a long-term strategy to move away from occasional, large-scale efforts to estimate the tax gap and instead update tax gap estimates on an ongoing basis. The IRS's FY 2009 budget included funding to improve tax gap estimates, better measure non-compliance, and improve detection of non-compliance.

[3] The IRS's top-level measures, goals, and timelines are published in the Appendix to its strategic plan, available at http://www.irs.gov/pub//newsroom/long_term_measures.pdf

As part of the effort to update the tax gap estimate, the IRS is currently completing a reporting compliance study on Subchapter S corporations for 2003 and 2004 tax years, and plans to release the results later this year. The IRS is also currently conducting research on reporting compliance with the individual income tax for tax years 2006 and 2007, and will soon begin looking at tax year 2008 tax returns (filed in 2009). The data for these three years will provide the necessary baseline for regular updates to the individual income tax gap, which can begin in calendar year 2011.

The IRS is also conducting a pilot project to extend studies of individual income tax returns to include a small sample of returns with international addresses. While the research is still in exploratory stages, if representative compliance data for this population can be extrapolated, this approach could allow us to better estimate one portion of the international tax gap.

Finally, the IRS is currently preparing to launch a study of employment tax reporting and filing compliance, with field work beginning in October 2009. This study will also be conducted over multiple tax years, with the goal of eventually providing regular estimates of employment tax compliance levels and the drivers of non-compliance.

In addition to developing more recent data on which to base an updated estimate of the tax gap, the IRS will also continue to explore ways to improve research methodologies to better measure non-compliance and to improve its ability to target the sources of non-compliance.

Status Update
The following chart provides a status update on the research and measurement efforts currently underway or completed since the release of prior tax gap reports:

Action Items	**Status**
Undertake additional compliance studies, including S Corporations and individuals	• Completed S Corporation exams (analysis ongoing) • Conducted TY2006 National Research Program (NRP) Form 1040 exams (analysis ongoing) • Conducting TY2007 NRP Form 1040 exams (ongoing) • Provide ongoing updates to level of tax gap attributable to underpayment (as shown in the Tax Gap Map, this amount is an actual amount, not an estimate)
Update tax gap estimates using new and existing data	• In process, as described above
Research the effect of service on taxpayer compliance	• Engaging in three significant research projects linking IRS service to compliance (in process)
Research the relationship between complexity, burden, and compliance	• Preparing survey of individual taxpayers to improve burden estimates (in process) • Engaging in three research projects

	focusing on relationships between complexity, burden, and compliance (in process)

Component 3: Continue Improvements in Information Technology

The IRS continues to focus on improving the technology infrastructure that supports its service and enforcement programs. Improved information technology capabilities will help make early detection and intervention efforts more effective, improve case selection, and allow the IRS to offer better, more user-friendly service to taxpayers.

Increasing E-File Rate
Electronic filing is a critical component of the effort to improve voluntary compliance and close the tax gap. By simplifying the filing process for taxpayers, decreasing processing errors, and expediting the processing and payment of tax refunds, electronic filing makes the tax-filing process less onerous for taxpayers and allows the IRS to update taxpayer records more efficiently.

Through sustained focus and outreach, the e-file rate has been steadily increasing for years. The 2008 e-file rate for individuals was 58 percent, up from 31 percent in 2001. Tax filing results thus far in 2009 already reflect a significant increase in this rate.

The Administration is committed to achieving an overall e-file rate of 80 percent. The IRS recent published an in-depth research study on ways to increase the e-file rate.[4] The study showed that approximately 85 percent of individual tax returns were filed by paid preparers, or by individuals via third-party software products. The study also showed that over 98 percent of paid preparer returns were completed using software, and yet a substantial number of tax returns are ultimately printed and mailed to the IRS. The Administration believes that in order to sustain progress toward the 80 percent goal, the Treasury should be authorized to require electronic filing from tax return preparers who file more than 100 tax returns in a calendar year. The President's FY 2010 budget includes the legislative proposal necessary to provide this authority.

Additionally, the IRS has been working on a modernized electronic filing (MeF) platform that provides real-time processing of tax returns and improves error detection. This new platform will improve detection of errors during the initial filing process, rather than after the fact, and will therefore reduce the number of filing errors that contribute to the tax gap. MeF is currently processing electronically filed tax returns for corporations, partnerships, excise tax filers, and exempt organizations. The number of tax returns filed through the MeF system increased 49 percent in 2008 to more than 3 million accepted returns, and volumes are projected to reach 4 million accepted returns for 2009. Starting in 2010, the IRS plans to roll out Form 1040 and its family of related schedules on the MeF platform, which will extend the benefits of the MeF platform to individual taxpayers as well.

[4] "Advancing E-file Study Phase 1 Report: Achieving the 80% E-file Goal Requires Partnering with Stakeholders on New Approaches to Motivate Paper Filers," Internal Revenue Service, Department of the Treasury, September 30, 2008.

Core Taxpayer Account Database
The IRS has made significant progress in updating its core taxpayer account database, the Customer Account Data Engine. Moving away from its legacy technology, the IRS has devoted resources towards a new, relational database structure, which will enhance the flexibility, responsiveness, and timeliness of the IRS' service and enforcement functions. Nearly 40 million taxpayer accounts were processed using this modernized taxpayer account database in 2009. This new database is the most important element of the IRS' strategy for the next generation of taxpayer service and compliance applications that are needed to address the tax gap. The Administration's FY 2010 budget includes a program increase of $23 million to accelerate this important work.

Applying Enhanced Information Technology to Ongoing Operations
The IRS continues to deliver significant enhancements to the systems that support its core operations. For example, the Automated Underreporter (AUR) program, a mechanized system that helps to identify discrepancies in returns, sends notices to taxpayers when amounts reported on individual tax returns and amounts reported by third parties don't match. Improvements to the AUR program have enhanced workload selection and improved the overall productivity of the program. AUR case closures have increased from 2.0 million in 2004 to 3.5 million in 2008. The expansion of the AUR program has allowed the IRS to increase coverage in key areas of non-compliance.

Status Update
The following provides a status update on the full range of information technology initiatives underway or completed since the release of previous tax gap reports:

Action Items	**Status**
Use technology to improve high income and non-EITC exam workload selection and method of delivery and assess the effectiveness of the exam treatment stream on selected non-filer cases	• Implemented new selection and classification criteria based on NRP results • Implemented automated case screening and selection process
Expand Automated Underreporter (AUR) program to include additional income types	• Expanded use of automatic notices
Evaluate the AUR matching process, and implement an improved case scoring and selection concept to select the most productive cases.	• Reengineered AUR matching process to improve coverage, maximize resource utilization, and increase AUR closures • Implemented improved workload selection tools
Expand the AUR Soft Notice Test, which involves asking taxpayers to voluntarily self-correct for future years	• Developed system requirements • Performed test for approximately 30,000 taxpayers in FY2009 and expect to perform follow-up test of 30,000 additional taxpayers in FY2010
Develop enhancements to the Compliance	• Completed

Data Warehouse to improve workload identification and prioritization algorithms, allowing better evaluation of alternative treatment streams and ensuring Collection cases receive the most efficient and effective treatments	
Update the Collection inventory management system to improve functionality and navigation and provide capability to interface with other modernized systems	• Nationwide deployment in process
Automate lien delivery, recording, and release processes with state and local jurisdiction to improve the timeliness of lien filing, lien releases, and the payment of fees	• Not yet started (currently unfunded)
Test the use of statistical modeling techniques within TEGE to detect high-risk compliance patterns in order to use data to expand and improve examination selection	• In process
Develop and implement a set of compliance decision analytic tools that will support analysis of Tax Exempt and Government Entities (TE/GE) returns and other data to detect compliance trends and improve case and issue selection	• In process
Implement a new TE/GE electronic examination system (TREES) that will consolidate agent work papers to increase the accuracy and efficiency of the examination process	• Completed
Build and implement modernized e-file (MeF) receipt of electronic transmissions for additional tax forms	• Deployed Form 1120F replacement in January 2008 and Form 990 replacement in January 2009 • Developing first phase of the Form 1040 series for deployment in 2010

<u>Component 4: Improve Compliance Activities</u>

Multi-Year Investment in IRS Enforcement
The Administration's FY 2010 budget continues strong support of IRS enforcement, which will support a sustained focus in the areas of greatest risk. The budget request includes program increases of $332.2 million for investments in strong compliance programs, including a robust portfolio of international enforcement initiatives. The priorities include international

enforcement, improving compliance programs dealing with businesses and high income individuals, expanding the use of document matching techniques to combat misreporting of income by business taxpayers, and improving collection operations, including the creation of two new Automated Collection System (ACS) sites.

The Administration's FY 2010 budget includes funding for an additional 15 tax specialists in Treasury's Office of Tax Policy. These new specialists will help to ensure that Treasury possesses capabilities sufficient to support rigorous analysis and implementation of revenue policy, including tax gap reduction.

The Administration's FY 2010 budget also outlines a multi-year investment to deal more effectively with the ever-increasing volume and complexity of international transactions. The initiative will add nearly 800 enforcement personnel to address the underreporting of tax associated with international transactions as well as domestic taxpayers involved with offshore activities.

The FY 2010 budget also contemplates a significant investment in enhancing and expanding the IRS' collection operation to address the tax gap attributable to underpayment of tax. From FY 2005 to FY 2008, the IRS achieved a 27.2 percent increase in collection efficiency, when over the same time period collection staffing decreased seven percent. The FY 2010 investment will allow the IRS to build on its efficiency gains, undertake pilot projects to further improve efficiency, and broaden overall collection coverage.

In total, the new enforcement personnel contemplated by the Administration's FY 2010 budget are estimated to generate $2.0 billion in additional annual enforcement revenue once the new hires reach full potential in FY 2012.

The IRS is constantly assessing the compliance landscape, and adapting and investing in its programs as needed to ensure an appropriate balance among its enforcement programs.

Status Update

Expanding on the new priorities and initiatives discussed above, the following chart provides a status update on the enforcement initiatives currently underway or completed since the release of prior tax gap reports:

Action Items	Status
Increase audit coverage and better target returns for examination	• Updated selection scores (DIF/Discriminate Information Function) based on NRP results • Increased Schedule C audits • Updating selection criteria based on results of NRP (in process) • Improving correspondence exam case selection methodologies (in process) • Began significant compliance hiring initiative in FY09

Enhance the ability to identify and address tax schemes of business and individuals involving offshore activity, address illegitimate use of tax havens to shelter income, and increase information matching and examination activity for individuals living abroad	• Working with Congress to secure requested FY 2010 funds for nearly 800 new international enforcement personnel. Funding request of $128M to increase international enforcement efforts. • Engaging in voluntary disclosure initiative for taxpayers with undeclared offshore accounts • Completed pilot phase of the Broker Compliance Initiative Project • Developing additional compliance initiative projects in the areas of private banking and offshore merchant accounts (in process) • Issued regulations relating to transfer pricing, foreign tax credits, and foreign trusts (regulations relating to cross border restructuring in process) • Implemented the Shelter Data Management System (SDM), and implementation of the larger Selection and Workload Classification system is in process • Expanded the use of the OECD Abusive Transaction Database to identify emerging abusive transactions and issues
Enhance collection programs and increase the Federal Payment Levy Program (FPLP) using third-party data	• Working with Financial Management Service (FMS) and Centers for Medicare and Medicaid Services (CMS) to determine feasibility of adding Medicare payments
Work with other federal agencies regarding FPLP	• Expanded FPLP to include Defense Finance and Accounting Service salary payment files, Department of Defense Civilian Employees, HHS, EPA, and Department of Energy • Entered into agreements with DoD to add additional Federal wage and other payments
Improve compliance by tax preparers through implementation of the Service-wide Enforcement Preparers Strategy	• Announced IRS review of tax return preparers (recommendations to be made by end of 2009)
Improve collection selection criteria and filters for balance due and non-filer cases, including identifying and addressing potential high income non-filers	• Expanded the use of third-party information and research to enhance case selection

	• Refining decision analytics and developing new model to enhance case selection (in process) • Finalized Service-wide non-filer strategy
Litigate cases, work settlements, and design large scale resolution initiatives for tax shelter transactions to deter noncompliance	• Engaged in settlement initiatives including Son of Boss, LILO/SILO, Distressed Asset Trust (DAT), stock option transactions, and the overall Global Settlement Initiative • Litigated and continued to litigate unresolved cases
Initiate a project using Combined Annual Wage Reporting (CAWR) data to identify tax-exempt organizations that may not be properly reporting and paying employment tax	• Analyzed results and documented lessons for future CAWR initiatives
Increase criminal enforcement on abusive schemes, corporate fraud, employment tax, egregious non-filers, and Bank Secrecy Act violations	• Achieved average conviction rate over 90 percent for the combined component programs and publicity rates over 80 percent
Improve the alignment and allocation of Service-wide resources to identify, develop, and resolve challenges better in the global taxation arena	• Moved forward with significant international compliance initiatives (in process) • Used International Planning and Operations Council to identify opportunities to conduct cross-divisional exams and enhance cross-divisional identification and referral of emerging international compliance issues • Realigned international resources to improve integration and leverage expertise • Increased international examiner hiring (ongoing) • Developing processes to evaluate referrals and identify and assess international and U.S. possessions compliance issues
Improve tax administration to deal more effectively with increased emphasis on globalization by all corporate and individual taxpayers	• Moved forward with significant international compliance initiatives (in process) • Expanded information sharing through increased membership and broader focus in the Joint International Tax Shelter Information Centre (JITSIC) by adding Japan, adding a London office, and adding

	China and Korea as observers • Introduced new Form M-3 for Form 1120F to gather information on foreign corporations • Revised Form 5471 for international transactions (in process) • Providing education and guidance to withholding agents of their responsibilities to withhold on Fixed, Determinable, Annual, Periodical (FDAP) payments to non-U.S. persons (ongoing)
Address offshore and cross-border compliance risks through enforcement and by issuing published guidance	• Completed project on foreign athletes and entertainers to ensure appropriate reporting and sourcing of income • Completed voluntary settlement initiative for embassy/consular employees and continuing to pursue enforcement activities on non-electors • Issued regulations on transfer pricing, foreign tax credits, cross-border restructuring, and other cross-border issues

Component 5: Enhance Taxpayer Service

Providing quality taxpayer service is critical to protecting the approximately $2.7 trillion that U.S. taxpayers report and remit. The tax code is complex, and effective taxpayer assistance is necessary to help taxpayers understand and comply with their obligations.

Providing Innovative Online Services
The demand for online services continues to grow dramatically. In FY 2008, IRS.gov received 2.2 billion web page visits, an increase of 74 percent from FY 2005. From January 1 to May 31, 2009, 48 million taxpayers used the “Where’s My Refund?” web site, up from 24 million for the same period in 2005.

In FY 2008, the IRS launched a hybrid online/in-person service with its Facilitated Self-Assistance Research Project. This project provides a kiosk with web access at IRS Taxpayer Assistance Centers. The kiosk computers allow taxpayers to help themselves and to get additional help from an IRS assistor if needed. Through FY 2009, the IRS has installed kiosk services in 50 Taxpayer Assistance Centers.

Streamline Written Communications with Taxpayers
In 2008, the IRS created a Taxpayer Communications Task Group to study and improve the clarity, accuracy, and effectiveness of written communications to taxpayers. Simple, clear communication makes it easier for taxpayers to comply with their obligations.

While the work of the group is ongoing, an early success was the elimination of nearly a dozen inserts in a notice informing businesses that they owe additional tax. This change to the CP 161 notice, which is mailed to business taxpayers who underpay their taxes, will halt the mailing of tens of millions of pieces of paper, reduce taxpayer and preparer burden, and save the government money.

Taxpayer Assistance Blueprint
The IRS continues to make progress in executing the initiatives outlined in its strategic plan for taxpayer service, the Taxpayer Assistance Blueprint (TAB). The TAB, which will be updated in the summer of 2009, outlines a series of initiatives aimed at enhancing IRS service options across all delivery channels: in person, on the Internet, and over the phone. The IRS has also embedded the philosophy and priorities of the TAB concept of improving service from the taxpayer perspective in every service improvement decision.

Status Update
The following chart provides an update on the status of the taxpayer service initiatives currently underway or completed since the release of prior tax gap reports:

Action Items	**Status**
Increase accuracy on toll-free telephone customer inquiries, processing functions, and paper adjustments	• Implementing and deploying Interactive Tax Law Assistant tool to provide accurate, efficient, and complete responses to basic tax law inquiries (in process) • Implementing and deploying Accessory Manager tools that provide standard research paths, consolidate account data, and automatically populate input fields (in process) • Implemented recommendations from the Correspondence Accuracy Improvement Study
Enhance IRS.gov	• Deployed interactive tax law decision support tool in FY 2009 filing season that includes enhanced FAQs • Preparing interactive probe and response capabilities (in process)
Improve the quality of volunteer-prepared returns through enhancements to the VITA program, including quality training and sample processing reviews	• Conducted on-site workshops to address quality concerns, and revised the volunteer return preparation training to use a process based training (PBT) approach for all volunteers. • Incorporating PBT concepts into online volunteer training application: Link & Learn Taxes (in process)

Enhance services to persons with limited English proficiency (LEP) through the Taxpayer Assistance Blueprint, development of a Multi-Lingual Strategic Plan, development of a Virtual Translation Office, and launch of a revised version of the Spanish IRS.gov webpage	• Added enhancements including "Where's My Refund?", "How Much Was My Economic Stimulus Payment?", and the Economic Stimulus Calculator to the Spanish IRS.gov • Undertook research efforts to pinpoint isolated community locations and identify actions to customize assistance • Performed targeted outreach for LEP taxpayers • Expanded Virtual Translation Office to provide tax forms, publications, and education materials in Spanish and other IRS-priority languages
Improve quality and timeliness of taxpayer contacts by maintaining an enhanced integrated quality assurance process with internal and external partners	• Developed and deployed Site Coordinator's Training, mandating use of intake and interview sheets and quality reviews for all return preparation. • Continued partner and employee feedback via roundtable discussions and partner satisfaction surveys • Implemented a Quality Statistical Sample Cadre to perform on-site return reviews that incorporates a second level review
Improve services through programs at both the national and local level by expanding collaborations with organizations serving the disabled, Native American communities, and pre-existing rural infrastructures	• Increased availability of free tax return preparation and financial/EITC education through a network of national and local partners in hard-to-serve Native American communities as well as for low income disabled persons • Working with Department of Agriculture and Rural Funding Foundations to increase availability of tax-related services in rural communities • Established measures to gauge national and local penetration rates for the rural initiative and shared best practices with rural partners
Expand and enhance the Spanish Website to increase electronic options, including options for Spanish language delivery of applications currently only in English	• Added "Where's My Refund?", "How Much Was My Economic Stimulus Payment?", and the Economic Stimulus Calculator to the Spanish website • Expanded and enhanced taxpayer education information including tax responsibilities and eligibility requirements for various credits and other

	benefits
Provide Reporting Agents with access to e-Services	• Deployed access to Electronic Account Resolution (EAR) and Transcript Delivery System (TDS) for Reporting Agents
Implement Taxpayer Assistance Blueprint Phase 2, which includes a five-year strategic plan for taxpayer service based on extensive research to understand taxpayer and stakeholder needs	• Embedded the TAB Guiding Principles within the FY 2009-2013 IRS Strategic Plan • Issuing in summer 2009 the second annual Report to Congress, which will include examples of numerous taxpayer service improvements accomplished in 2008 and 2009
Implement Internet-Customer Account Services (I-CAS) Release 1, which will enable taxpayer to view account information	• Working toward electronic access to account information, once all data security issues are resolved and the core taxpayer account database complete
Implement I-CAS Release 2, which will enable taxpayers to change their address, file an extension, submit a Power of Attorney, and calculate a payoff amount on balances due via a secure Internet link	• Status is same as above
Continue publicity efforts encouraging use of Online Payment Agreement (OPA)	• Issued new releases and other communications during filing seasons, including directions for accessing OPA from IRS.gov • Worked with tax software providers and other stakeholders to promote OPA
Enable taxpayers with disabilities to understand available tax credits and receive tax preparation assistance through partnerships with national and local organizations that serve this unique group of taxpayers	• Partnering with national and local organizations, including government entities, to increase return preparation services

Component 6: Reform and Simplify the Tax Law

Earlier this year, the President's Economic Recovery Advisory Board (PERAB) formed a Task Force on Tax Reform. The task force will, among other things, focus on tax simplification. The task force will report back to the board, and the full board is expected to report back to the President with options.

The following is a more detailed listing of specific action items that are underway by the IRS and Treasury to reform and simplify the tax law.

Initiatives	**Status**

Work with Congress to enact simplification legislative provisions	• Enacted simplifications to create uniform definition of a child
Continue Taxpayer Burden Reduction projects	• Released revised Forms 1120S and 2553, along with related regulation changes, to simplify an S Corporation election • Released revised Form 94X, along with related regulation changes, to reduce employment tax reporting errors • Released new Form 8857 for innocent spouse relief
Continue tax form and publication improvements	• Among other improvements, developed a multi-year prioritized plan of burden reduction activities to include forms redesign and simplification, defined the MeF platform for XML-enabled PDF Form 1040, and launched a hyperlinked Publication 17, Your Federal Income Tax, on IRS.gov

Component 7: Coordinate with Partners and Stakeholders

Tax Return Preparer Review
The IRS recently announced that, by the end of 2009, the Commissioner will propose a comprehensive set of recommendations concerning tax return preparers. The review seeks to identify ways to improve taxpayer compliance and to ensure strong and uniform ethical standards of conduct for tax preparers.

Potential recommendations could focus on a new model for the regulation of tax return preparers, improved service and outreach for return preparers, education and training for return preparers, and enforcement related to return preparer misconduct.

The tax return preparer review will begin with a fact-finding effort targeted at a large and diverse constituent community, including both licensed tax preparers—such as enrolled agents, lawyers and accountants—and unlicensed tax preparers and software vendors. The effort will also seek input and dialogue with consumer groups and taxpayers.

Enhanced Collaboration with Partners and Stakeholders
The IRS has strengthened its partnerships with other state and Federal agencies. Strong collaboration enables the IRS and its partner agencies to make more efficient and effective use of existing resources. For example, the IRS has undertaken initiatives to make better use of information from state agencies, including state audit reports, and has developed a coordinated strategy to combat employment tax schemes.

Finally, the IRS has expanded its partnership with stakeholders to communicate more effectively with the numerous constituencies whose efforts might help raise the level of voluntary compliance. Examples include work with the Small Business Administration to educate new business owners on key tax topics, and expanded work with partners to communicate with military retirees on retirement-related tax issues.

Status Update
The following chart provides a status update on coordination efforts currently underway or completed since the release of prior tax gap studies:

Action Items	Status
Enhance the centralized process to maximize utilization of State Audit Reports (SARs) by IRS for federal assessments	• Established a system to establish baseline usability and productivity of incoming SARs • Continue to partner with states to implement enhancements (including automation of receipts) to improve usability of SARs
Implement a Questionable Employment Tax Practices (QETP) Initiative in partnership with the Department of Labor, National Association of State Workforce Agencies, Federation of Tax Administrators, and state workforce agencies to provide a collaborative national approach to combat employment tax schemes	• Implemented initiative with initial 20 states participating, with 25 percent participation increases targeted and achieved in FY08 and FY09 • Incorporated data provided by the states into employment tax audit work streams
Further enhance the Fed/Fed program by facilitating and expanding partnerships with other Federal agencies to improve tax administration	• Expanded partnerships to include the Social Security Administration (SSA) and the Small Business Administration (SBA)
Engage all 50 states through the State Reverse File Match Initiative (SRFMI) – a process that matches IRS extracts received through the Governmental Liaison Data Exchange Program against state master files to identify individuals and businesses who filed a state return but not a federal return and to identify differences in federal and state income reporting	• Engaged in 2008 pilot use of systemic SRFMI data received from 14 states, and increased state agency participation to 44 agencies in 2009 • Expansion in process
Determine tax administration benefits of utilizing state data warehouse concept	• Evaluating internal systems such as Compliance Data Warehouse and Integrated Production Model to determine feasibility
Develop an educational targeted outreach DVD for military personnel preparing for	• Distributed and integrated DVD into all military pre-retirement seminars to ensure

retirement	retirees understand tax rules applicable to their retirement benefits • Working with Department of Labor to include a topic on withholding taxes as a requirement for all military retiree training conducted on military bases and developing a Life Cycle Brochure on this topic for distribution
Enhance outreach efforts to industry audiences about available Audit Technique Guides and Tax Tips	• Determined what enhancements to current guides and what new guides are needed • Continued to publicize availability of guides via national and local liaison activities
Establish links to IRS.gov on industry, practitioner, educational, and governmental stakeholder websites	• Established Tax Centers (dedicated web space) with links to state and national organization websites
Develop and widely distribute educational fact sheets on areas of high noncompliance	• Distributed monthly fact sheets on wide variety of subject matters including avoiding incorrect self-employment deductions, wage compensation for S Corporation officers, and managing paper and electronic recordkeeping requirements
Develop a strategy to reach practitioners without affiliation to a professional organization	• Developed grass-roots delivery channel with national retail tax preparation firms, expanded outreach to colleges and universities to include graduates entering tax field
Leverage key partners such as the SBA and its SCORE program and Small Business Development Centers (SBDCs) to deliver small business workshops to the new business community	• Continued contact with traditional partners to maximize leveraged opportunities that provide education and outreach directly to business owners • Partnered with SCORE and SBDCs to enhance quality and consistency of leveraged Small Business Tax Workshops • Partnered with SBA to increase outreach through the National Women's Business Council in order to promote voluntary compliance and share information customized for new business owners • Increased the number of Small Business Tax Workshops
Deliver educational messages through existing relationships with universities and colleges	• Expanding participation of current Historically Black Colleges and Universities (HBCUs) in the VITA program (in process)

	• Increasing participation of Beta Alpha Psi, national scholastic and professional fraternity, in VITA program by 10% (in process) • Expanding the Cooperative Extension Services Network tax prep and education program in each of the four regions, HBCUs, tribal colleges and universities (in process)
Develop audio educational messages for toll-free wait times	• Developed text and appropriate placement of specific educational messages • Deploying audio educational messages (expected July 2009)
Customize outreach to specific industries to encourage voluntary compliance	• Launched industry specific communication and outreach to small businesses, industry stakeholders, and state licensing agencies • Performing outreach in all states to promote use of IRS's web-based Tax Centers designed to provide education and web resources for specific industries and professions (in process) • Provided educational materials to new and existing business owners through partnerships with small business and industry stakeholders and state licensing agencies in all 50 states
Request feedback from internal and external stakeholders on existing outreach and educational programs to identify best practices and enhancements	• Convened IRS-wide task force to collect and review stakeholder feedback, shared recommendations with external stakeholders, and obtained additional feedback (implementation of recommendations ongoing)
Develop strategies to educate first-time business filers	• Implemented outreach strategy to first-time business filers including collaboration with small business and industry partners to develop an outreach campaign to educate first time Schedule C filers, including common errors to avoid
Expand relationships and collaboration with foreign tax administrations to increase informal and formal communications on international tax administration matters	• Completed OECD project relating to international guidelines on attribution of profits to permanent establishments • Participating in OECD work on monitoring Transfer Pricing Guidelines, including international business restructurings (ongoing)

	• Negotiated protocols to income tax treaties with Luxembourg and Switzerland to make the exchange of information provisions consistent with U.S. and OECD standards • Continuing efforts to conclude tax information exchange agreements, including agreements recently signed with Liechtenstein and Gibraltar • Participating in the Leeds Castle Group with the tax administration agencies of China, India, South Korea, the United Kingdom, Japan, Australia, Canada, France, and Germany (ongoing) • Collaborating via the Joint International Tax Shelter Information Centre (JITSIC) with Canada, Australia, and the United Kingdom to identify and curb abusive tax avoidance transactions (ongoing) • Participating with the OECD working group on Aggressive Tax Planning to design a database of various cross-border tax avoidance schemes (ongoing)

V. IRS Strategic Plan

Since the publication of the last tax gap report, the IRS published a new strategic plan for FY 2009-2013. The strategic plan outlines the service and enforcement goals of the IRS, along with the strategic foundations that underpin both. The plan recognizes that the IRS must excel at both service and enforcement: success is not an either/or proposition. The plan also outlines five long-term measures for evaluating the IRS's progress in achieving its goals, and which directly relate to the tax gap strategy. Those measures, some of which have been discussed above, include the following:

- Voluntary Compliance Rate. The Voluntary Compliance Rate, as explained earlier in this report, is highlighted in the strategic plan as a key long-term measure. The IRS's goal is to achieve an 86 percent voluntary compliance rate for Tax Year 2009, and is actively pursuing updates to the tax gap estimates that will allow progress against this goal to be measured.

- E-File Rate. The IRS has been tracking the rate of electronic filing for individual income tax returns since the inception of electronic filing in 1986, reporting the number of individual tax returns (Form 1040) that have been filed electronically in its published performance reports. The IRS is currently seeking to achieve an 80 percent e-file rate by 2012 for all major tax returns filed with the IRS.

- ACSI All Individual Taxpayer Score. The American Customer Satisfaction Index (ACSI) is a national indicator of customer satisfaction with the quality of products and services available to consumers in the United States. Each December, the ACSI issues a report on satisfaction of recipients of services from the Federal government. In 1999, the Federal government selected the ACSI to be a standard metric for measuring citizen satisfaction. Agency participation is voluntary but relatively extensive. Over 55 Federal government agencies have used the ACSI to measure citizen satisfaction of more than 110 services and programs. The IRS performance measure focuses on the satisfaction score associated with all individual income tax filers (paper and electronic filers). The IRS has a goal of achieving a satisfaction score of 72 for the 2012 tax year. As discussed above, a taxpayer-friendly tax filing process is essential to improving compliance.
- Nonrevenue Enforcement Activity. IRS has developed an index of enforcement activities that promote compliance yet do not focus primarily on tax revenue. IRS examines changes in this index in order to assess trends in its nonrevenue performance, which is similar to using the Consumer Price Index to assess trends in consumer prices. The nonrevenue enforcement activity index includes examination activity in the Tax Exempt and Government Entities Division as well as Bank Secrecy Act investigations.
- Employee Engagement. A motivated, well-trained, and dedicated workforce is critical to the ultimate success of all IRS initiatives. The IRS for several years has been conducting an annual employee survey to obtain feedback on a wide range of workplace issues. The results are used to calculate an engagement index, which is compared with engagement scores from prior years and from other agencies.

Recognizing the importance of a well-trained workforce to the accomplishment of the goals and metrics outlined in the strategic plan, the IRS last summer launched a Workforce of Tomorrow Task Force. The Task Force's goal is to ensure that, five years from now, the IRS has a workforce equipped to serve America's taxpayers for the next fifteen years. The Task Force produced a roadmap of initiatives to address the IRS's greatest workforce challenges, which includes 58 recommendations that are currently being implemented. The IRS workforce is the foundation for the ultimate success of its efforts to implement its strategic plan and reduce the tax gap.

Conclusion

The tax gap imposes an unfair burden on law-abiding taxpayers, and the Department of the Treasury and the IRS are committed to narrowing the gap between what is owed and what is paid. This report has highlighted new initiatives to improve tax revenue collection, both through improved voluntary compliance and through effective enforcement. It has also provided status updates on a full range of initiatives currently underway or completed since the release of previous tax gap reports.

As outlined above, the plan to reduce the tax gap has multiple parts. Targeted changes in the tax laws, enhanced taxpayer service, and increased enforcement are all critical to this effort. As this report describes, progress has already been made with respect to key strategic priorities and initiatives, both those identified in prior tax gap reports and those developed since the issuance of the last report. In order to provide accurate and up-to-date assessments of progress, Treasury and IRS are deploying significant resources toward the long-term effort to produce regular, updated estimates of the tax gap, which will be used to assess progress toward closing the tax gap.

The Administration's FY 2010 budget proposes an expansive set of additional tools and requirements to reduce opportunities for evasion and other non-compliance. The Administration is committed to working closely with Congress to strike an appropriate balance to maximize revenue collection without imposing unreasonable compliance and enforcement burdens on the vast majority of individuals and businesses that fully and willingly pay what they owe.

APPENDIX: UNDERSTANDING THE TAX GAP[5]

The Internal Revenue Code places three primary obligations on taxpayers: (1) to file timely returns; (2) to make accurate reports on those returns; and (3) to pay the required tax voluntarily and timely. Taxpayers are compliant when they meet these obligations. Noncompliance — and the tax gap — results when taxpayers do not meet these obligations.

The tax gap is defined as the aggregate amount of true tax liability imposed by law for a given tax year that is not paid voluntarily and timely. True tax liability for any given taxpayer means the amount of tax that would be determined for the tax year in question if all relevant aspects of the tax law were correctly applied to all of the relevant facts of that taxpayer's situation. For a variety of reasons, this amount often differs from the amount of tax that a taxpayer reports on a return. The taxpayer might not understand the law, might make inadvertent mistakes, or might misreport intentionally.

To be paid voluntarily, a tax liability must be paid without direct IRS intervention. Taxpayers have the responsibility to determine and report their correct tax liability, and to make sure that amount is paid (whether through withholding, estimated tax payments, payments with a filed return, etc.). The IRS focuses its enforcement where it is needed most, but the overall rate of tax compliance in the United States is as high as it is because the vast majority of taxpayers meet their obligations with little or no involvement from the IRS. To be paid timely, a tax liability must be paid in full on or before the date on which all payments for the given tax year were legally due.

It is important to emphasize that IRS estimates of the tax gap are associated with the legal sector of the economy only. Although tax is due on income from whatever source derived, legal or illegal, the tax attributable to income earned from illegal activities is extremely difficult to estimate. Moreover, the government's interest in pursuing this type of noncompliance is, ultimately, to stop the illegal activity, not merely to tax it.

Although they are related, the tax gap is not synonymous with the "underground economy." Definitions of the "underground economy" vary widely. However, most people characterize it in terms of the value of goods and services that elude official measurement. Furthermore, there are some items in the "underground economy" that are not included in the tax gap (such as tax due on illegal-source income), and there are contributors to the tax gap that no one would include in the "underground economy" (such as the tax associated with overstated exemptions, adjustments, deductions, or credits, or with claiming the wrong filing status). The greatest area of overlap between these two concepts is sometimes called the "cash economy," in which income (usually of a business nature) is received in cash, which helps to hide it from taxation.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to tax law complexity that results in errors of ignorance, confusion, and carelessness. This distinction is important even though, at this point,

[5] This section is reproduced from "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," Internal Revenue Service, Department of the Treasury, August 2, 2007, pp. 6-9.

the IRS does not have sufficient data to distinguish clearly the amount of noncompliance that arises from willful, as opposed to unintentional, mistakes. Moreover, the line between intentional and unintentional mistakes is often a grey one, particularly in areas such as basis reporting, where a taxpayer may know that his or her reporting is inaccurate but does not have ready access to accurate information. This is an area where additional research is needed to improve understanding.

Measuring the Tax Gap

Historically, estimates of federal tax compliance were based on special studies, including the Taxpayer Compliance Measurement Program (TCMP), which covered income and self-employment taxes and groups of taxpayers, and consisted of line-by-line audits of random samples of returns. These studies provided the IRS with information on compliance trends and allowed the IRS to update audit selection formulas regularly. However, this method of data gathering was extremely burdensome on the taxpayers whose returns were selected. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done in 1988.

The IRS conducted several much narrower compliance studies between 1988 and 2001, but nothing that would provide a comprehensive perspective on the overall tax gap. Until recently, all of these subsequent estimates of the tax gap have been rough projections that basically assume no change in compliance rates among the major tax gap components even though the magnitude of these projections reflects growth in tax receipts in these major tax gap categories.

The NRP, which the IRS has used to estimate the most recent tax gap updates, arose out of a desire to find a less intrusive means of measuring tax compliance. The IRS used a focused statistical selection process that resulted in the selection of approximately 46,000 individual income tax returns for Tax Year (TY) 2001 — somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time.

Like the compliance studies of the past, the NRP was designed to allow the IRS to meet certain objectives — to estimate the overall extent of reporting compliance among individual income tax filers and to update the audit-selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The first NRP innovation was to compile a comprehensive set of data to supplement what was reported on the selected returns. The sources of the “case building” data included third-party information returns from payers of income (e.g., Form W-2 and Form 1099) and prior-year returns filed by taxpayers. Also, for the first time, the IRS added data on dependents obtained from various government sources, as well as data obtained from public records (e.g., current and prior addresses, real estate holdings, business registrations, and involvement with corporations). Together, these data reduced the amount of information requested from taxpayers, with some of the selected taxpayers not requiring any contact from the IRS. In effect, these data allowed the IRS to focus its efforts on return information that could not otherwise be verified. This pioneering approach was so successful it is being expanded in regular operational audit programs.

A second major NRP innovation was to introduce a “classification” process, whereby the randomly selected returns and associated case-building data were first reviewed by experienced auditors (referred to as classifiers) who identified not only which issues needed to be examined, but also the best way to handle each return in the sample. In this way, each return was either: (1) accepted as filed, without contacting the taxpayer at all (although, sometimes, minor adjustments were noted for research purposes); (2) selected for correspondence audit of up to three focused issues; or (3) selected for an in-person audit where there were numerous items that needed to be verified. In addition, the classifiers identified compliance issues that the auditor was required to evaluate, although the examiners had the ability to expand the audit to investigate other issues as warranted.

Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders (including representatives of tax professional associations) in the design and implementation of the study. Clearly, the NRP approach was much less burdensome on taxpayers than the old TCMP audits, which examined every line item on every return.

Tax Gap Estimates

As noted above, for the 2001 tax year, the overall gross tax gap was estimated to be approximately $345 billion, corresponding to a noncompliance rate of 16.3 percent. After accounting for enforcement efforts and late payments, the amount was reduced to $290 billion, corresponding to a net noncompliance rate of 13.7 percent.

Noncompliance takes three forms:

- Not filing required returns on time (nonfiling);
- Not reporting one’s full tax liability on a timely filed return (underreporting); and,
- Not timely paying the full amount of tax reported on a timely return (underpayment).

The IRS has separate tax gap estimates for each of these three types of noncompliance. Underreporting (in the form of unreported receipts and overstated expenses) constitutes over 82 percent of the gross tax gap, up slightly from earlier estimates. Underpayment constitutes nearly 10 percent and nonfiling almost 8 percent of the gross tax gap.

<u>Nonfiling</u>

The nonfiling gap is defined as the amount of true tax liability that is not paid on time by taxpayers who do not file a required return on time (or at all). It is reduced by amounts paid on time, such as through withholding, estimated payments, and other credits. The nonfiler population does not include legitimate nonfilers (i.e., those who have no obligation to file).

<u>Underreporting</u>

The underreporting gap is defined as the amount of tax liability not voluntarily reported by taxpayers who file required returns on time. For income taxes, the underreporting gap arises from three errors: underreporting taxable income, overstating offsets to income or to tax, and net math errors. Taxable income includes such items as wages and salaries, rents and royalties, and net business income. Offsets to income include income exclusions, exemptions, statutory adjustments, and deductions. Offsets to tax are tax credits. Net math errors involve arithmetic mistakes or transcription errors made by taxpayers that are corrected at the time the return is processed. In addition to developing an estimate of the aggregate underreporting gap, it is possible to break aspects of this estimate down into measures of the underreporting gap attributable to specific line items on the tax return.

Underpayment

The underpayment gap is the portion of the total tax liability that taxpayers report on their timely filed returns but do not pay on time. This arises primarily from insufficient remittances from taxpayers themselves. However, it also includes employer under-deposits of withheld income tax. In the case of withheld income tax, it is the responsibility of the employees to report the corresponding tax liability on timely filed returns, and it is the responsibility of their employers to deposit those withholdings with the government on time.