

**TESTIMONY
of**

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**before the
SENATE COMMITTEE ON FINANCE**

**on
THE TAX GAP AND TAX SHELTERS**

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Mr. Chairman, Senator Baucus, and members of the Committee, thank you for inviting me to testify here today on approaches to reducing the tax gap. I commend the Committee and Commissioner Everson for their efforts in highlighting this issue. The tax gap has dogged tax administration since its inception. The good news is that, to the best of our knowledge, the taxpaying public pays approximately 85 percent of the taxes it owes. The bad news is that the taxpaying public does not pay approximately 15 percent of taxes due.¹

I. THE SIGNIFICANCE OF THE TAX GAP TO MOST TAXPAYERS

The tax gap has real victims. Individuals and businesses that evade tax impose a significant burden on those who comply with their tax obligations. If we divide the 2001 net tax gap estimate of \$255 billion by 130 million individual taxpayers,² we can see that each of those taxpayers in 2001 paid, on average, an extra \$2,000 to subsidize the unwillingness or inability of some taxpayers to pay their fair share.

As the National Taxpayer Advocate – the advocate for *all* taxpayers as well as specific taxpayers – I am concerned about the economic and social costs that this noncompliance imposes. In fact, in my 2003 Annual Report to Congress, I identified the tax gap as the most serious problem facing taxpayers, after the AMT. It comes down to a simple issue of fairness.

II. A FRAMEWORK FOR ENFORCEMENT ACTIONS

The Internal Revenue Service is now mounting a vigorous response to the tax gap and has identified major aspects of the gap as enforcement priorities through 2009.³ As the IRS expands its enforcement initiatives going forward, it is important that the IRS develop the best possible framework for determining how to allocate its resources – in terms of enforcement, taxpayer education, taxpayer assistance, and protection of taxpayer rights.

¹ Since 1973, compliance with the Federal income tax by individuals and corporations on legal-source income has been relatively constant, hovering between 81 and 85 percent. American Bar Association Commission on Taxpayer Compliance, *Report and Recommendations on Taxpayer Compliance*, 41 Tax Law. 329, 334 (1988) [hereinafter the “ABA Report”].

² This reference to “taxpayers” refers to the number of returns filed, including joint returns.

³ Internal Revenue Service, *Strategic Plan 2005 – 2009*, Publication 3744 (Rev. 06-2004), pp. 18-25.

A. Use National Research Program Data

The foundation for any resource allocation should be the National Research Program (NRP) data.⁴ Although it does not provide a perfect snapshot of noncompliance, the NRP data should certainly constitute the starting point in determining the size of the tax gap and its key components.

B. Map Enforcement Initiatives to the Tax Gap

Different components of the tax gap will require different strategies and approaches. Thus, any recommendation for an enforcement initiative should be “mapped” to the tax gap. For example, if the IRS were to develop a comprehensive return preparer strategy, it might adopt one approach for preparers of individual returns with small businesses and self-employment income and another approach for preparers of high-income individual or corporate returns. Each of the tax gap components presents its own unique set of challenges.

C. Understand and Address Causes of Noncompliance

Once the key components of the tax gap have been identified and analyzed, we should consider (1) the causes of noncompliance and (2) ways to reduce the opportunity for noncompliance. By understanding what triggers or causes a taxpayer or segment of taxpayers to be noncompliant, the IRS can choose the appropriate method to foreclose noncompliance opportunities, be it expanding withholding of taxes at the source, increasing third-party payment reporting, or increasing information sharing between government agencies. Any proposed approach must be weighed against the taxpayer’s privacy rights and expectations, the taxpayer’s statutory and other due process rights, and the potential expense and other burden on compliant taxpayers.⁵

Traditionally, the IRS allocated resources by balancing revenue loss against the cost of collection actions. This approach, however, only takes into consideration direct revenue loss. Taken to the extreme, under this analysis, the IRS would only conduct audits on corporate and high-income individuals and on low-income taxpayers who receive the Earned Income Tax Credit (EITC). In fact, this

⁴ The National Research Program (NRP) is a comprehensive cross-functional effort by the IRS to measure reporting, filing and payment compliance for different types of taxes and different groups of taxpayers. NRP information will help the IRS identify areas of noncompliance on which to focus, thereby improving voluntary compliance. The IRS has been without such information for more than a decade. NRP currently reports payment compliance data for all types of tax across IRS Operating Divisions as well as filing compliance data for individual income taxpayers. NRP is also charged with measuring reporting compliance at a strategic level – it is currently conducting a study of individual income taxpayers and is in the planning stages of a pilot study of flow-through entities (i.e., partnership and S corporation returns).

⁵ ABA Report, *supra* note 1, at 331.

description comes fairly close to summarizing the IRS examination program today.

If one adds *indirect* revenue loss into the equation, however, one might devise a very different enforcement strategy. We really don't understand the impact of our enforcement actions very well. What is the ripple effect of a few well and strategically placed audits? Do such audits result in less revenue loss than more numerous but poorly targeted audits? What is the impact of these two examination approaches on future compliance by the audited and other taxpayers? How effective are "soft" touches such as warning letters, self-audits, and even information campaigns?

Subject to the completion of the NRP, the best data we have today show that the largest portion (over 40 percent) of the tax gap arises from the underreporting of business income by individuals, which contributes to both the individual income tax gap and the employment tax gap (\$81 billion and \$51 billion, respectively, out of a \$310 billion gross tax gap for 2001).⁶ The IRS estimates that three-quarters of the employment tax gap may arise from self-employed individuals, including independent contractors.

Breakout of Employment Tax Gap⁷

Type of Tax	TY2001 Tax Gap (\$B)	Percent Distribution
FICA tax	14	22
Self-Employment (SECA) tax	51	77
Unemployment (FUTA) tax	1	1
TOTAL	66	100

Clearly, we cannot ignore a compliance problem of this magnitude. Individual business income underreporting has two components – underreporting of actual business receipts and over-reporting of business expenses. Although all types of individual business income are underreported – farms, non-farm proprietorships, rents, royalties, and partnerships – farm and non-farm sole proprietorships are the largest source of underreported income. Approximately one-third of these income sources do not show up on tax returns – either for income or self-employment tax purposes.⁸

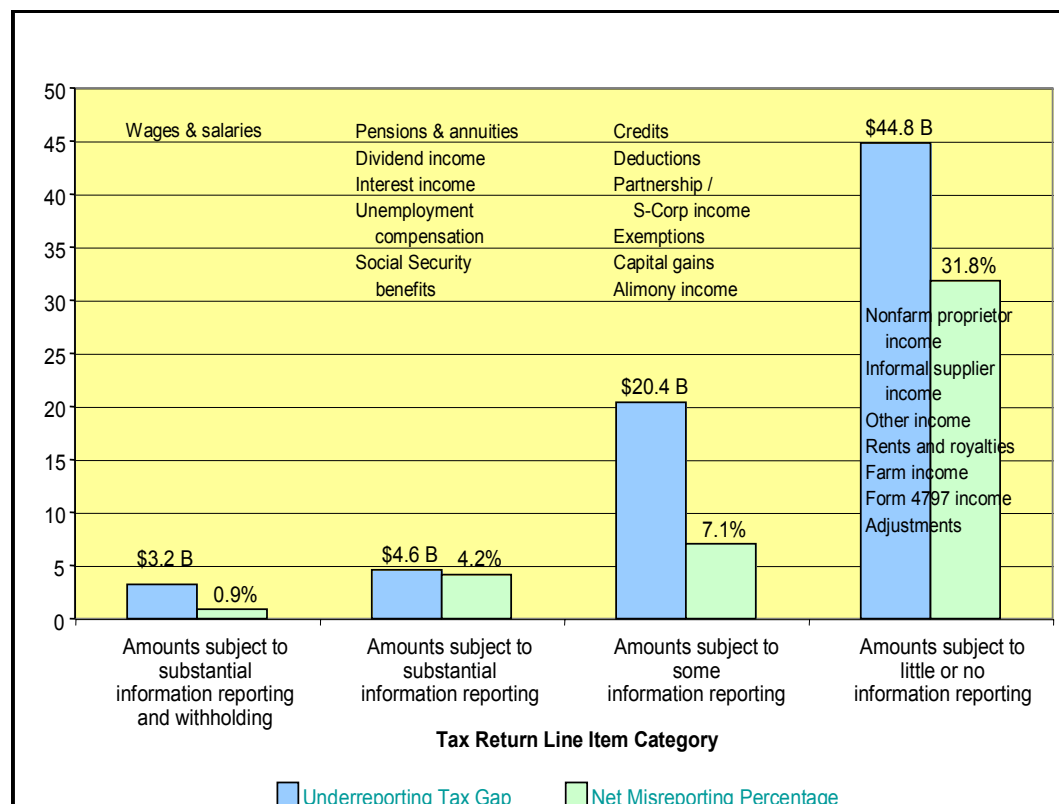
⁶ IRS National Headquarters, Office of Research, *Tax Gap Map for Tax Year 2001*.

⁷ *Id.*

⁸ IRS National Headquarters, Office of Research, July 2004. The underreporting of income is often referred to as the Net Misreporting Percentage (NMP). The NMP shows the percentage of income that is not reported after netting underreporting of income and overreporting of offsets to income, such as deductions and exemptions. The NMP for self-employed taxpayers is estimated at 32 percent.

This relatively high rate of underreporting of income among sole proprietors is largely due to the general absence of information reporting by third parties on their earnings. Prior research studies show that reporting compliance depends directly on the "visibility" of the relevant transactions – i.e., the degree to which a type of income is subject to information reporting determines the degree to which it is "visible" to the IRS. This relationship is clearly demonstrated in the following chart:

Underreporting of Income By "Visibility" Categories Individual Income Tax, Tax Year 1992⁹



Admittedly, increasing tax compliance by sole proprietors, particularly informal suppliers,¹⁰ presents considerable challenges. This income is often in the form of

⁹ Tax Year 1992 is the last year for which line-item compliance measures have been published. See Internal Revenue Service, *Individual Income Tax Gap Estimates for FY 85, 88 and 92*, Publication 1415 (Rev. 04-1996).

¹⁰ Informal Suppliers are the least compliant proprietors. This category includes a broad range of sole proprietors who operate in an informal business style—typically with poor or nonexistent books and records, often on a cash basis, and often anonymously with no fixed place of business. Examples include street vendors, roadside stand operators, door-to-door salesmen, and moonlighters.

cash payments or without a paper trail. Under a traditional cost-benefit analysis, one might not even try to increase compliance. It simply costs too much to recoup a small per-taxpayer revenue loss; arguably, for the same expenditure of resources, one could get a better return on investment by auditing one high income individual. Because noncompliance by self-employed persons constitutes the largest single component of the tax gap, however, we cannot just walk away from this compliance problem. We need to develop a more creative approach.

D. Reduce Opportunities for Noncompliance

The two most effective steps Congress and the IRS can take to reduce the opportunities for noncompliance in this sector are (1) enforce existing, and expand, third-party information reporting requirements and (2) expand withholding at the source.

1. 1099 Reporting Compliance

Based on the 1988 Tax Compliance Measurement Program and other studies (all conducted more than a decade ago), various researchers have found that information reporting is strongly associated with much lower rates of misreporting by individual taxpayers. For example, wage income is almost entirely subject to both information reporting and withholding, with the result that less than one percent of wage income is estimated to be underreported on individual income tax returns.¹¹ In contrast, over 30 percent of sole proprietor income is thought to be underreported, and over 80 percent of informal supplier income is believed to be underreported.¹² These extremely high misreporting percentages appear to arise because these types of business income are subject to little, if any, third-party information reporting. Other types of compensation that are subject to information reporting but not to withholding (e.g., pensions and annuities) exhibit a misreporting percentage on the order of four to five percent – not quite as good as wage income, but still quite low.¹³

Based on these earlier data, we would expect that independent contractor earnings and other forms of personal compensation that are not currently subject to third-party information reporting are probably underreported to an extent somewhere between the rates associated with established sole proprietors and informal suppliers – perhaps on the order of 50 percent underreported.¹⁴ However, if these types of compensation were to become subject to information reporting, we would expect them to be reported much like other forms of personal

¹¹ IRS National Headquarters, Office of Research, July 2004.

¹² *Id.*

¹³ *Id.*

¹⁴ IRS National Headquarters, Office of Research, July 2004. An independent contractor is subject to income reporting if income earned is greater than \$600 per person per year.

compensation that are subject to such information reporting – on the order of about 5 percent underreported.¹⁵ In other words, we would expect the introduction of information reporting to induce much greater taxpayer compliance.

Given the connection between income reporting and compliance, one might be tempted to require that *all* economic transactions be reported. Of course, that would impose significant, and in some cases unacceptable, burdens on taxpayers and the economy.

Fortunately, there are less burdensome alternatives involving information reporting. For starters, the IRS can do much more with the information it already has on hand. Although the IRS requires reports of non-employee compensation, these income reports are difficult to match to amounts reported on tax returns because they are lumped in with gross receipts on the tax form. If the IRS simply redesigned its Schedule C, Profit or Loss From Business (Sole Proprietorship), to include two separate lines for reporting income – one line for “receipts shown on 1099s” and one line for “other receipts” – the IRS would be able to conduct more accurate document matching. Further, because the IRS would be signaling that it is looking more closely at the source of gross receipts, taxpayers might feel pressured to report more non-1099’d income, thereby increasing compliance further.

Another approach to increasing reporting compliance is to ask a taxpayer on Schedule C or Schedule F, Profit or Loss From Farming, to affirmatively declare, under penalties of perjury, whether he or she paid more than \$600 to any one individual or partnership during the calendar year. If the taxpayer answers this question in the affirmative, then the taxpayer must indicate on the schedule whether he or she filed the appropriate Forms 1099 reporting these payments.¹⁶

These two simple questions would confront the sole proprietor with his or her obligation to file income reports. Those taxpayers who were unaware of this requirement would be put on notice. For those taxpayers who weren’t making reports because the recordkeeping is annoying and burdensome or who think the IRS is too busy to find them, the stakes and attendant risks would suddenly rise. For taxpayers who persist in assisting others in avoiding taxes by not making third party income reports after being explicitly queried on the tax schedule, well, the IRS would now have more ammunition to go after them. Either way, these two simple questions would “out” those taxpayers who are hiding independent contractor payments in cost of goods, or professional services, or miscellaneous expense categories.

With respect to informal suppliers, we could attempt to address this difficult problem by negotiating information sharing agreements with localities and states

¹⁵ *Id.*

¹⁶ ABA Report, *supra* note 1, at 360.

that issue licenses. For example, localities that issue street vendor licenses could provide us with the names and addresses of vendors. With this information, the IRS could develop a local project for auditing a few of these vendors. The audit would specifically examine whether the vendor reported to the IRS payments made to those individuals staffing the vendor's carts. Having identified the vendor's subcontractors, the IRS would examine the subcontractor's returns to ensure that the subcontractors reported all income earned. This type of audit – what I call the “infection audit” – is highly effective in close-knit work communities. It does not take a large number of these audits to have a significant effect on compliance, since the presence of the IRS spreads quickly throughout the community by word of mouth. A regular cycle of these audits would put the message out on the street that the IRS is no longer a sleeping giant.

Many locally or state-issued licenses require a statement by the applicant estimating his or her annual gross receipts. For example, contractor's licenses are often issued in classes based on the dollar threshold of construction projects. If the IRS obtains this information from the states or localities, it can identify taxpayers who have never surfaced before or whose state or local license applications report gross receipts different from the amounts shown on their tax returns. In some cases, a simple inquiry from the IRS may prompt increased compliance.

Finally, Congress should consider expanding income reporting to corporations, perhaps linking it to a size criterion. As the American Bar Association has observed:

Establishing reasonable and equitable criteria for reporting is a difficult task, but we believe that differentiating corporations from individuals and partnerships without considering size or complexity is arbitrary and inappropriate. Incorporated individuals and businesses should not have more opportunity for noncompliance than unincorporated ones of comparable size.¹⁷

The absence of a third-party reporting requirement for small corporations enables taxpayers to avoid the scrutiny of the IRS by the mere act of incorporation.

2. Non-wage Withholding

Internal Revenue Service data indicate that where withholding at the source is imposed, income reporting is nearly 100 percent.¹⁸ In my 2003 Annual Report to Congress, I recommended withholding on non-wage payments, as both the Government Accountability Office (GAO; formerly the General Accounting Office)

¹⁷ ABA Report, *supra* note 1, at 359.

¹⁸ IRS National Headquarters, Office of Research, July 2004.

and the Treasury Inspector General for Tax Administration (TIGTA) have recommended previously.¹⁹ Since issuing my report in January 2004, I and my staff have met with over thirty groups representing the interests of small business and have discussed our proposal and their concerns. While many of these groups continue to express concerns about our proposal, we believe this approach should be seriously studied.²⁰

Certainly, no one wants to increase burdens on small business. As a matter of basic fairness, however, the size of the tax gap compels us to explore non-wage withholding. I believe that there are several ways to impose withholding at the source, or offsets on non-wage payments, while keeping the burden on the payor to a minimum. For example, the IRS could enter into voluntary withholding agreements under IRC § 3402(p)(3)(A) and (B) with various trades or industries. Congress could expand the Service's back-up withholding authority under IRC § 3406 to apply in specific taxpayer cases where there is a demonstrated history of noncompliance. The IRS could use its Federal Payment Levy authority under IRC § 6331(h) to offset Federal payments, including payments to Federal contractors. And Congress could authorize the IRS to require withholding, where practicable, when NRP data indicate significant underreporting in a specific trade or industry.

3. Noncompliance by Federal Contractors

Every federal agency head who enters into certain contracts is required by the Internal Revenue Code to file two information-reporting documents with the IRS.²¹ Form 8596, Information Return for Federal Contracts, provides information about contract recipients, including the date of contract action and

¹⁹ See Hearing on *Compliance Problems of Independent Contractors*, GAO # 109909, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, 96th Cong. 7 (1979) (statement of Richard L. Fogel, Associate Director, General Government Division, General Accounting Office); see also GAO Report to Congressional Requesters, *Tax Administration, Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108, July 1992, p. 4; General Accounting Office, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, May 11, 1994, p. 37; GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *Tax Administration: Tax Compliance of Nonwage Earners*, GAO/General Government Division, GGD-96-165, August 1996, p. 12; Treasury Inspector General for Tax Administration, *Significant Tax Revenue May be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors*, Reference # 2001-30-132, Aug. 2001, p. ii.

²⁰ In the 1940s, when wage withholding was implemented, similar concerns were expressed. One witness told the House Ways and Means Committee that wage withholding was "perhaps the most burdensome and impracticable plan that has ever been seriously proposed by any responsible public official." Hearings Before the Committee on Ways and Means on Revenue Revision of 1942, 77th Cong. (vol. I), 620 (1942) (statement of Laurence Arnold Tanzer). Yet wage withholding has been an extraordinary success story from the standpoint of Federal revenue, and it explains in large part why the U.S. has one of the highest tax compliance rates in the world.

²¹ IRC § 6050M.

the total amount to be obligated under the contract. Form 1099-MISC, Miscellaneous Income, reports the amount paid each year to contractors. For purposes of Federal contract reporting, these forms are required to report contracts and amounts paid to corporations as well as individuals.²²

Despite the fact that two documents are required to be filed with the IRS, the IRS does not have data on overall noncompliance by Federal contractors. Moreover, the IRS does not know whether Federal agencies are filing required Forms 8596 or whether agencies filing Forms 8596 on Federal contractors also file the required Form 1099-MISC reporting payments to those contractors.

The Taxpayer Relief Act of 1997 established the Federal Payment Levy Program, which authorizes the IRS to continuously levy up to 15 percent of certain federal payments.²³ The IRS sends a file of delinquent accounts subject to levy to the Financial Management Service (FMS), which manages the collection of delinquent Federal debt. Yet, according to a GAO report issued in February 2004, over 27,000 Department of Defense contractors owed \$3 billion in unpaid taxes, and many contractors continue to receive contract payments without paying federal taxes owed.²⁴

Form 8596 only reports the total contract amount obligated, the date of contract action, and the expected date of contract completion. Thus, the IRS can't match Form 8596 reported contract amounts with Form 1099 reports of amounts actually paid under the contract. With these pieces of information, however, an IRS matching program could determine tax return filing compliance and 1099 filing compliance. (As I discussed above, there is a strong correlation between income reporting compliance and overall compliance.) Further, the Form 8596 would alert the IRS to the fact that there is a future income stream available as a

²² No information return is required for any contract of \$25,000 or less; any contract with a contractor who is acting in his or her capacity as an employee of a federal executive agency; any contract between a federal executive agency and another federal government unit; any contract with a foreign government; any contract with a state or local government unit; any contract with a person who is not required to have a TIN; any contract whose terms provide that all amounts will be paid on or before the 120th day following the date of the contract action; any contract under which all money (or other property) that will be received by the contractor after the 120th day after the date of the contract action will come from persons other than a federal executive agency or an agent of such an agency (e.g., a contract under which the contractor will collect amounts owed to a federal executive agency by the agency's debtor and will remit to the agency the money collected less an amount that serves as the contractor's consideration under the contract); or any contract for which the IRS determines that information described in Treas. Reg. § 1.6050M-1 will not facilitate the collection of federal tax liabilities because of the manner, method, or timing of payment by the agency under that contract. IRC § 6050A; Treas. Reg. § 1.6050M-1(c)(1).

²³ Taxpayer Relief Act, Pub. L. No. 105-34, § 1024(a)(1)-(2) (1997) (amending IRC § 6331).

²⁴ General Accounting Office, GAO Report to Congressional Requesters, *DOD Pays Billions of Dollars to Contractors That Abuse the Federal Tax System*, GAO-04-95, February 2004. DOD dispersed \$86 billion to federal contractors in FY 2002 that was matched. DOD is not matching payment information from its 15 vendor payment systems, which dispersed another \$97 billion to contractors in FY 2002.

levy source. These processes can be automated so they are not, after start-up, heavily resource intensive. Yet these processes would enable the IRS to “touch” the taxpayer and remind the taxpayer that the Service is, in fact, paying attention to tax compliance. This signaling would have a positive effect on taxpayer compliance.

E. Reinvigorate Local Compliance Activity

Prior to the recent IRS reorganization into four operating divisions, geographically based District offices provided local information during the development of the Annual Compliance Plans. These plans consisted of several components and outlined activities and goals for the various compliance functions such as collection, examination, and criminal investigation. Some portion of the Annual Compliance Plan was dedicated to locally generated segment-based compliance initiatives. The locally based portion was primarily formulated and overseen by local Compliance Planning Councils.

Compliance Planning Councils’ membership included both compliance division chiefs and the local research offices, as well as noncompliance related division chiefs where appropriate. The council served as a cross-divisional forum for discussion of local, area, or regional compliance issues and determined which initiatives to study, test, and implement at the local level based on factors such as local compliance expertise and resources. This process allowed District Directors to “opt out” of nationally mandated market-segment-based work when it could be demonstrated that the local compliance levels were within tolerance or were of negligible significance. In this instance, resources could be redirected to the locally defined compliance work identified by the council.²⁵

These initiatives are sorely needed at this time and are a way to address the largest portion of the tax gap, individual business income (self-employed) underreporting. Local initiatives could be developed in partnership with state and local tax authorities to address a demonstrated area of local noncompliance, such as the initiatives relating to informal suppliers like street vendors discussed above.²⁶ Through research, the partnership could determine what approaches will be most successful – including soft letters, office audits, or field audits. Local initiatives can be very helpful in learning about how information is disseminated through groups within a community. Designed properly, a local initiative can accomplish a great deal with very few resources.

²⁵ Compliance Planning Councils also sought alternative treatments for compliance issues when appropriate. They looked for ways to solve a compliance issue prior to the examination, appeals, and collection processes. Alternative treatments saved human capital resources that could be used in more effective ways.

²⁶ In practice, state sales and use tax agents and representatives of the state unemployment tax commissions almost always beat the IRS to the door of noncompliant taxpayers.

F. Monitor Tax Return Preparers

1. The Role of Tax Return Preparers in Noncompliance

For Tax Year 2002, the latest year for which data are available, over 55 percent of individual income tax returns were prepared by a commercial tax return preparer or other tax professional.²⁷ Tax return preparers perform a vital function in assisting taxpayers in meeting their tax obligations. In fact, for many taxpayers, tax return preparers are the gatekeepers to the tax system. Thus, the quality of return preparation can make a taxpayer's interaction with the tax system a positive and uneventful one, or an adversarial and negative one. Tax preparers can contribute to noncompliance either through incompetence or by fostering a sense that noncompliance is acceptable.

The IRS is aggressively investigating practitioners who facilitate improper transactions by corporate taxpayers and wealthy individuals. It is doing virtually nothing, however, about unskilled and unscrupulous preparers who serve middle and lower income taxpayers. The Government Accountability Office has found that the IRS rarely levies penalties against preparers, and even when it does, it collects only 12 percent of those penalties.²⁸ This inaction not only enables noncompliance but also injures those preparers who are competent and ethical and who must compete with unregulated, incompetent, or unscrupulous preparers.

For two years now, I have advocated for regulation of unenrolled return preparers. Senate Bill 882, the Tax Administration Good Government Act, directs the IRS to do just that – by requiring unenrolled return preparers to register with the IRS and demonstrate their competency.²⁹ My office has met with virtually every major association representing return preparers, and we are currently conducting focus groups with return preparers at the Tax Forums this summer to discuss the details of this proposal. We have also talked with organizations and businesses that administer licensing programs for states and localities.

What we have learned to date is that competent preparers will accept a regulatory scheme so long as it is not overly burdensome, because certification distinguishes them from fly-by-night, unskilled preparers. We have heard many good suggestions, including requiring registration once every five years instead of annually, and providing a continuing education alternative to the annual update exam (following the initial entrance exam). We have learned that licensing programs administered by contractors can be self-funding without imposing

²⁷ Internal Revenue Service, *Statistics Of Income Bulletin Winter 2003-2004*. Calculated from Selected Historical and Other Data (Tables 1 and 23).

²⁸ General Accounting Office, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS Is a Challenge*, GAO-04-70, October 2003.

²⁹ S. 882, § 141.

significant costs on licensees, thereby allowing valuable resources to be applied to enforcing compliance with the regulatory requirements.

We have also heard concerns about the proposed public information campaign required by S. 882. We are committed to ensuring that all types of licensed preparers – attorneys, Certified Public Accountants, enrolled agents, and those certified under S. 882 – will be identified and promoted by the campaign. In fact, the point of this consumer campaign is to warn taxpayers away from unqualified preparers and to educate taxpayers about the different types of preparers, including the limitations on or extent to which they can practice before the IRS. We look forward to working with the IRS and preparers to design a program that enables the majority of taxpayers to feel confident that their preparers are competent to prepare their taxes and that the IRS will punish preparers where they perform negligently or recklessly.³⁰

2. Preparer Penalties Should Be Strengthened and Enforced

In addition to regulation of unenrolled preparers, the IRS needs to enforce the preparer penalties that are on the books today, and Congress should strengthen and enhance those penalties. At \$50 per violation, preparers view many of the penalties as simply a risk of doing business, and a modest one at that. Other penalties, including the penalty for failure to sign a return, do not fully address the preparer abuses we see today. For example, preparers who are not authorized to practice before the IRS under Circular 230 prepare offers in compromise, Collection Due Process Hearing requests, and financial statements, which constitute IRS practice. None of these documents requires a preparer signature, and there are no preparer penalties for failure to sign.

Approximately 65 percent of taxpayers who claimed the Earned Income Tax Credit in 1999 used paid return preparers.³¹ Almost half of the EITC returns filed in 1999, including those filed by paid preparers, involved an EITC overclaim.³² The Associated Press recently reported that thousands of returns filed by Somalis located in Minnesota, claiming inflated refunds, were prepared by “corrupt tax preparers.”³³ One social worker in the community noted that the Somalis are the victims in this case. He stated that “most Somalis have little

³⁰ We note that regulation of unenrolled return preparers is not merely directed at preparers of Earned Income Tax Credit returns or purveyors of Refund Anticipation Loans. Many small businesses are unable to afford the services of CPAs or even enrolled agents. An uninformed preparer can wreak havoc on a small business’ finances. See National Taxpayer Advocate, *2002 Annual Report to Congress*, Publication 2104, (Rev. 12-2002), Example at 217.

³¹ Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2001.

³² Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (February 28, 2002), p. 11.

³³ Associated Press, *Tax-preparer scheme implicates 3,500 Somalis with suspect tax returns*, Duluth News Tribune, May 23, 2004, available at <http://www.DuluthNewsTribune.com>.

understanding about tax credits and deductions, which are unheard of in Somalia.”³⁴ To counter just this type of egregious and predatory activity, Congress should hold preparers jointly and severally liable for any resulting EITC overpayment when they prepare EITC returns in reckless disregard of IRS rules and regulations.³⁵

III. THE IMPORTANCE OF RESEARCH TO ACHIEVING AN EFFECTIVE COMPLIANCE STRATEGY

A. Compliance Strategies Should Be Based on Current Data

The IRS is currently making its resource allocation decisions relating to enforcement and compliance activities on the basis of Tax Compliance Measurement Program (TCMP) data that is sixteen years old. Obviously, we cannot get the National Research Program (NRP) results soon enough. We also must continue to conduct the kind of core research represented by the NRP on an ongoing basis.

B. Compliance Strategies Should Address the Causes of Noncompliance

It is not enough, however, to rely on NRP data alone in designing tax compliance strategies. While NRP data will tell us *where* we should focus our energies, it will not tell us *how* we should increase compliance in those areas, or *what* type of approach we should take. To increase compliance, the IRS needs a better understanding of why certain taxpayers are not complying with the law and what steps might cause or help them to comply. For many taxpayers, it’s simply a question of what they can get away with, but that’s not the case for everyone.³⁶

In general, the IRS is faced with three types of taxpayers:

1. Taxpayers who are actively complying with the tax laws;
2. Taxpayers who are trying to comply with the tax laws or who would comply if they knew what the laws required of them; and
3. Taxpayers who do not want to comply with the tax laws and are not trying to do so.

³⁴ *Id.*

³⁵ For a complete discussion of the National Taxpayer Advocate’s proposals regarding the EITC preparer penalties and the EITC due diligence requirement under IRC section 6695(g), see National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003), p. 272.

³⁶ It has been noted that most criminal laws are proscriptive, i.e., in order to comply, a person must refrain from doing an act, such as killing or using drugs. Tax laws, on the other hand, are prescriptive. In order to comply, a person must take certain affirmative actions, such as keep records, file, and pay. This level of complexity leads to a high degree of inadvertent noncompliance as well as the deliberate sort. ABA Report, *supra* note 1, at 351-352.

The IRS' goal must be to adopt policies and procedures that will move all taxpayers into Group 1 (compliant). Its challenge is to adopt a strategy that acknowledges there are differences between Group 2 (trying to be compliant) and Group 3 (noncompliant) taxpayers.

The membership in these three groups of taxpayers is fluid. That is, persons who are attempting to comply can easily be transformed into compliant or noncompliant taxpayers, depending in large part on their experience with the IRS. Taxpayers who are compliant can fall out of compliance as a result of a catastrophic event such as a divorce or illness. And noncompliant taxpayers can, in fact, "see the light," if only out of fear of the consequences of their noncompliance.

An effective compliance strategy would not be identical for the two noncompliant groups. For those taxpayers who are trying to be compliant, it is important to help them – and not to push them into noncompliance through enforcement tactics that frighten them from coming into the IRS to clear up past problems so they can make a fresh start. By contrast, for those persons who consciously choose to evade tax, a more heavy-handed approach would seem appropriate.

In order to design such a strategy, the IRS must conduct research into the motivation of noncompliant taxpayers. The IRS needs to understand why taxpayers don't comply with the law before it can significantly increase compliance. There is general agreement that traditional incentive-based models fail to fully explain the dynamics of tax compliance.³⁷ Clearly, there are also other factors involved. In fact, a recent survey commissioned by the IRS Oversight Board found that the strongest factor influencing tax reporting is personal integrity (88 percent), with 73 percent of respondents saying it has a great deal of influence on their behavior.³⁸ Taxpayers reported that other factors have much less of an influence, including third party reporting of income (64 percent), fear of an audit (59 percent), and believing that their neighbors are reporting and paying honestly (38 percent).³⁹

Professor Leslie Book of Villanova University School of Law recently adapted sociological research in other areas to develop a typology of tax noncompliance. Professor Book identified at least eight types of noncompliance:

³⁷ Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145, 1178 (2003).

³⁸ IRS Oversight Board, *2003 Compliance Study Report*, prepared by RoperASW, September 2003, p. 10 [hereinafter the "Roper Study"].

³⁹ *Id.* at 10. Despite the strong belief in their personal integrity, an increasing percentage of people cite fear of an audit as the factor that keeps them honest (+ 8 points from last year for those who say fear of audit has a great deal of influence). There has also been a slight increase in citing third-party reporting as the reason for compliance (+ 4 points).

- *Procedural noncompliance*: Administrative complexity is a hurdle to compliance.
- *Lazy Noncompliance*: Taxpayers are unwilling or unable to satisfy the requirements for compliance.
- *Unknowing Noncompliance*: Taxpayers experience confusion about the rules for compliance.
- *Asocial Noncompliance*: Taxpayers engage in classic tax cheating.
- *Brokered Noncompliance*: Taxpayers' reliance on advice of tax professional results in noncompliance.
- *Symbolic Noncompliance*: Taxpayers do not comply because they perceive inequities in the operation of the tax laws or tax administration.
- *Social Noncompliance*: Social or economic circumstances create an environment that does not discourage cheating.
- *Habitual Noncompliance*: Taxpayers develop a history of noncompliance and become emboldened by "getting away" with noncompliance in past years.⁴⁰

This variety of underlying causes for noncompliance should convince anyone that NRP data, which identify the type of noncompliance (individual, employment, corporate), must be supplemented with research into the causes of noncompliance.

C. Tax Schemes "Tipping Point" Study

The Taxpayer Advocate Service is sponsoring research, conducted by the IRS Office of Program Evaluation and Risk Analysis (OPERA), that exemplifies the focus on understanding taxpayer compliance behavior and will allow the IRS to develop more effective compliance strategies. The goal of the study is to identify methods that will enable the Service to evaluate emerging abusive tax schemes, such as abusive corporate tax shelters and the slavery reparations scheme, and to prevent their dissemination. The research study is divided into two phases.

The objective of Phase I, which was completed on August 1, 2003, was to identify the approaches the IRS has developed that enable early identification of abusive tax avoidance schemes and mitigate their impact. The end product of Phase I was a comprehensive inventory of IRS activities in these areas. (See Appendix A.)

⁴⁰ See Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003). Professor Book draws largely from the social science perspective offered by Professors Robert Kidder and Craig McEwen. See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 *Taxpayer Compliance* 47 (1989).

Phase I results show that the IRS units have identified a wide variety of shelters and schemes. They have also recently formed bodies to coordinate their efforts. Collectively, the IRS's efforts to combat abusive schemes demonstrate a significant commitment of resources. The range of mitigation strategies it employs includes public information and alerts, new disclosure requirements for promoters and participants, other outreach and communication to affected areas, examination and investigation, and litigation. This range illustrates the value of a coordinated and balanced approach combining outreach and enforcement to attain compliance.

A major challenge confronting the IRS is to build upon the work that has been done to become more proactive in our detection, evaluation, and mitigation strategies. This will allow us to better target and leverage our finite resources to prevent the growth of emerging schemes and minimize their impact.

Building upon the taxonomy of schemes developed in Phase I, the second phase of the study, which began in April 2004, will track the course of "infection" of certain schemes among the taxpayer public. The schemes chosen for analysis are the "home based business" and "claim of right" schemes.⁴¹ The study will attempt to identify who were the key "agents" of the scheme, what paths provided the most fruitful dissemination, and what particular aspect of the scheme appealed to the population so that they were persuaded to participate.⁴²

Statistical modeling techniques are being applied to IRS data sources to look for patterns within schemes. The goal is to identify any common characteristics among schemes, promoters, and participants that might assist with early identification of emerging tax schemes and mitigation of their impact on taxpayers and the IRS. The team is also evaluating the application of behavioral modeling techniques to supplement findings from the statistical modeling study currently being conducted.

D. Inherent Limitations of IRS Research

While I've spoken about the importance of using research data well, and I believe the IRS research staff is second to none, it's important that people understand the inherent limitations on the accuracy of the data. In short, we don't know what

⁴¹ "Claim of Right" schemes consist of frivolous or fraudulent requests for refunds citing IRC § 1341, in which a taxpayer attempts to take a deduction equal to the entire amount of his wages. The taxpayer typically submits a Form 1040 or Form 1040X reporting wage income and other income items and attaches a Schedule A claiming a miscellaneous itemized deduction on the ground that the wages are deductible because they are compensation for personal labor which is not taxable, or because there was an equal exchange of labor and/or services for the amount claimed.

⁴² This aspect of the study relies heavily on the concept that an idea can act as an epidemic, as discussed in Malcolm Gladwell's book, *The Tipping Point: How Little Things Can Make A Big Difference* (2000).

we don't know. And that's true both for estimated underpayments of tax and estimated overpayments of tax.

On the underpayment side, the IRS cannot determine with accuracy how many persons were required to file tax returns but didn't, or how much illegal source income went unreported. While the IRS can make estimates of under-reporting generally, the estimates are only estimates. For example, the IRS might audit an electrician who performs jobs for both businesses and homeowners and was paid by some homeowners in cash. If the electrician did not report some or all of the cash transactions, it is difficult for the IRS to determine how much income went under-reported, yet its estimates of unreported income rest on audits of taxpayers just like this one.

On the overpayment side, the IRS knows that millions of taxpayers fail to claim all the credits, such as the EITC, and other deductions for which they are eligible, but it does not attempt to project how much of a Federal revenue windfall results from taxpayer failure to claim those benefits. In addition, it is significant that the IRS has a high no-response rate for of much of its correspondence, including correspondence examination notices.⁴³ Thus, IRS adjustments may simply reflect default adjustments and not state the correct amount of tax due. In FY 2002, for example, the Taxpayer Advocate Service closed more than 30,000 cases involving the IRS's EITC Revenue Protection Strategy examinations, and in more than half of the cases, the IRS ultimately agreed to a change in the result determined at the examination level.

Therefore, while IRS's compliance strategy should be based on the best research we have, no one should blindly cite the research conclusions as if they present a perfect snapshot of reality. They can't and they don't.

IV. THE MORAL DIMENSIONS OF TAX COMPLIANCE

The IRS Oversight Board's 2003 Compliance Study Report found that 81 percent of individual taxpayers believe that no form of cheating on taxes is acceptable, down from 87 percent in 1999.⁴⁴ The report also found that although 95 percent of taxpayers at least "mostly agree" that paying taxes is a civic duty, since 1999 the proportion of taxpayers who "completely agree" that it is every American's civic duty to pay their fair share of taxes has steadily declined, from 81 percent in 1999, to 72 percent in 2002, to 68 percent in 2003.⁴⁵

⁴³ Data provided by the EITC Program Office to TAS for FY 2003 indicate nearly a 40 percent no response/undeliverable rate for EITC correspondence. The no response/undeliverable rate including Statutory Notice of Deficiency is 53 percent.

⁴⁴ Roper Study, *supra* note 38, at 6.

⁴⁵ *Id.* at 9.

To me, however, the most interesting finding of the Oversight Board's study pertains to taxpayers' expressed preference for whom the IRS should enforce the laws against. Not surprisingly, taxpayers want the IRS to go after corporations (83 percent say it is very important) and high-income individuals (79 percent).⁴⁶ Yet only 70 percent and 63 percent of taxpayers say it is very important to enforce the tax laws against small businesses and low-income taxpayers.⁴⁷ There is clearly a "not in my backyard" mentality at play here, which creates a dissociation of tax compliance from personal integrity and civic duty.

I believe that the Congress, the Administration, and the IRS must make the case that paying taxes is a civic duty. We can disagree and advocate about how the tax laws are structured and about the rate and incidence of taxation. But once these decisions are made, taxpayers must make their best efforts to comply.

We need to shift taxpayers' focus from using someone else's noncompliance as an excuse to not comply. We must appeal to that strong element of personal integrity that the Oversight Board's study suggests is the strongest factor influencing compliant behavior. We must make taxpayers see that noncompliance has its victims and that its victims are us. We facilitate noncompliance by our silence, in a thousand little ways – by our failure to object when someone at a neighborhood barbecue gloats and jokes about not reporting certain income or deducting personal expenses on a business return or by agreeing to pay a child-care provider in cash at a lower rate of pay than when the payments are reported to the IRS.

We need to make it clear that it is not okay to cheat on your taxes. In 1988, the American Bar Association Commission on Tax Compliance noted that it is not easy to modify prevailing norms and attitudes toward tax compliance. It recommended, however, that Congress authorize a broad-based public information campaign, modeled after the campaigns against smoking and drunk driving. Such a campaign would have three basic messages:

1. Tax cheating has direct and indirect victims.
2. Tax cheating is a widespread social problem and does not affect just a few people.
3. Everyone should attempt to influence the behavior of others: just say NO to tax cheating.⁴⁸

I believe this proposal should be resurrected and considered. Such a campaign could be designed to build upon the findings of the Oversight Board Study and appeal to the personal integrity of all U.S. taxpayers. The campaign, coupled with media coverage about IRS efforts to identify, deter, and punish taxpayers

⁴⁶ *Id.* at 16.

⁴⁷ *Id.* at 16. With respect to low income evaders, the percentage increased by 7 points from 2002.

⁴⁸ ABA Report, *supra* note 1, at 383.

who cheat, could go far in making taxpayers not feel like chumps if they comply with the tax laws.

V. BALANCING TAX ENFORCEMENT AGAINST TAXPAYER RIGHTS

The tax system historically has struggled to achieve the right balance between enforcing the tax laws and respecting taxpayer rights. Indeed, perceptions about IRS shortcomings have often led to fitful shifts between emphasis on enforcement and emphasis on taxpayer rights. As the IRS is now stepping up enforcement activities, it is the role of the National Taxpayer Advocate to help ensure that the aggressive enforcement of the tax laws is balanced by the aggressive protection of taxpayer rights. Moreover, it is the role of TAS to serve as the safety valve for any excesses or oversights that might occur during the implementation of enforcement initiatives.

In my most recent report to Congress, delivered on June 30, I focused on the protection of taxpayer rights as a mandatory component of tax administration. I noted that enforcement of taxpayer rights assures taxpayers that the IRS' enforcement of the tax laws will be balanced and fair. It is easy to give lip service to the term "taxpayer rights" but much more difficult to incorporate this concept into action. My report identified three measures to bolster the protection of taxpayer rights:

A. Taxpayer Rights Impact Statement

The IRS often implements new procedures, guidelines, or requirements that further its enforcement or administrative goals but may place a significant burden on the time, rights, or privacy of taxpayers. In 1998, Congress strengthened the Office of the Taxpayer Advocate and created the Taxpayer Advocate Service (TAS) to act as a safety valve when institutional tendencies within the IRS do not adequately take account of taxpayer rights. Beginning immediately, the Office of the Taxpayer Advocate will prepare a Taxpayer Rights Impact Statement (TRIS) on major initiatives to help the IRS incorporate an awareness of taxpayer rights into its program planning and implementation. If the IRS function responsible for developing an initiative asks for our input during the planning phase, our taxpayer rights perspective can be incorporated into the initiative's design. I think this is preferable. However, if the IRS does not request a TRIS prior to program implementation, TAS will analyze programs on its own accord, if and when appropriate.

B. Improved IRS Employee Training

Over the next few years, the IRS plans to hire thousands of new employees as part of its initiatives to strengthen its enforcement of the tax laws. For these

employees to pursue tax noncompliance aggressively yet fully respect taxpayer rights, they require training in the foundational, technical, and behavioral aspects of tax administration, including training in the importance of world-class customer service and respect for taxpayer rights. During FY 2005, the Office of the Taxpayer Advocate will study key aspects of the IRS training program for new employees and make recommendations consistent with its objectives.

C. Increased Awareness of the Taxpayer Advocate Service

Other functions of IRS generally are and should remain the first point of contact for taxpayers needing assistance with their problems, but taxpayers must be better informed that TAS is available as a backstop when regular IRS procedures fail. A recent study commissioned by TAS indicates that approximately 1.5 million taxpayers at any given time meet the statutory “significant hardship” test and thereby qualify for TAS assistance. Thus, as part of IRS employee training, employees should be educated about existing guidelines for referring cases to TAS. In addition, the study found that approximately 43 percent of taxpayers who qualify for TAS assistance at any given time report that they feel intimidated by the IRS. They therefore are unlikely to call the IRS to obtain assistance and are in danger of becoming habitually non compliant. The Office of the Taxpayer Advocate has developed an outreach strategy to inform this taxpayer population about TAS and its ability to assist these taxpayers in resolving their tax problems.

VI. CONCLUSION

The Commissioner has made it clear that the IRS is back in the business of tax law enforcement, and that is a good thing. But it is essential that the IRS strive to maintain a balance between enforcing the laws and protecting taxpayer rights. A balanced approach protects taxpayer rights as aggressively as the law is enforced. A balanced approach acknowledges that not all taxpayers who make errors are intentionally noncompliant, and recognizes that different noncompliant behaviors require different responses. It strives to support and appreciate taxpayers who are complying with tax laws, to provide assistance, education, and opportunities (including gentle persuasion) to taxpayers who are attempting to comply, and to take firm, direct, and immediate action against taxpayers who do not want to comply. A balanced approach does not ignore areas of noncompliance simply because they are difficult to deal with. It includes creative approaches to intractable problems. And it does it on a solid foundation of research, so that valuable and limited resources are used wisely and effectively.

APPENDIX A: ABUSIVE SCHEMES “TIPPING POINT” STUDY

[For electronic copies, the Abusive Schemes “Tipping Point” Study will be transmitted as a separate file.]