# WRITTEN TESTIMONY OF
# COMMISSIONER OF INTERNAL REVENUE
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# BEFORE
# THE SENATE COMMITTEE ON THE BUDGET
# ON
# THE FY 2008 IRS BUDGET AND THE TAX GAP

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### Introduction

Good morning Chairman Conrad, Senator Gregg, and Members of the Committee on the Budget. I am pleased to be here this morning to discuss the President's FY 2008 Budget request, and the IRS' efforts to improve compliance with our nation's tax laws.

### A Commitment to Service *and* Enforcement

In FY 2006, we continued making improvements in both our service and enforcement programs. This is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards "transforming itself into a modern institution that provides efficient and effective tax administration services to America's taxpayers."

### *Improving Taxpayer Service*

According to a survey commissioned by the Board in 2006, taxpayers increasingly recognize that the IRS provides good quality service through a variety of channels, such as its Web site, toll-free telephone lines and Taxpayer Assistance Centers. This is supported by the metrics that we use to measure the effectiveness of our taxpayer service efforts. In category after category we continue to see improvement in the numbers in our telephone services, electronic filing, and our IRS.gov access. This is demonstrated by the following:

- Electronic filing by individuals continued to increase, up 6 percent from TY 2005 (3 percentage points) to 54 percent of all individual returns.
- The level of service for toll-free assistance was 82 percent, about the same level of 2005 and up substantially from 2001. The level of customer satisfaction with the toll-free line remains 94 percent, the same as last year.
- The tax law accuracy of toll-free response improved to 91 percent from 89 percent in the prior year.
- Taxpayers continued to find IRS.gov a useful source of information about the tax system and how to comply with their tax obligations. Visits to the IRS Web site jumped nearly 10 percent in 2006 to more than 193 million visits.

- More taxpayers used the online refund status tool "Where's My Refund." In 2006, there were 24.7 million status checks, up nearly 12 percent from 2005.

Clearly, more work needs to be done by the IRS to improve services. But we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July, 2005 through a Congressional mandate. We sent Phase 1 of the Blueprint to Congress in April, 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer, partner, and government value:

- Improve and expand education and awareness activities: This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.
- Optimize the use of partner services: This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.
- Enhance self-service options to meet taxpayer expectations: This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.
- Improve and expand training and support tools to enhance assisted services: This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.
- Develop short-term performance and long-term outcome goals and metrics: This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

Phase 2 of the Blueprint will be sent to Congress soon. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year Strategic Plan for taxpayer service.

The Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The Strategic Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder, partner, and employee engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance. More details on TAB Phase 2 will be available when the report is delivered to Congress.

While TAB remains a work in progress, the FY 2008 budget request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the Blueprint. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help.

The Blueprint also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding non-compliance, the FY 2008 budget includes funding for research to understand better the effect of service on compliance.

***Expanding Enforcement Efforts***

Another reason for the Oversight Board's positive assessment of our work in FY 2006 is that IRS enforcement efforts have increased in virtually every area. According to the Board, "As demonstrated by a variety of measures, the IRS' performance on enforcement has improved considerably, and real progress has been achieved over the past six years."

One of the most obvious measures is the increase in enforcement revenue, which has risen from $34 billion in FY 2002 to almost $49 billion in FY 2006, an increase of 44 percent. Since 2003, Federal government receipts have also increased by $600 billion. In FY 2006, the Federal government collected over $2.4 trillion in total receipts. This is an historic level, with annual receipts up 12 percent over FY 2005 alone. In the past two years the U.S. has seen the highest year-to-year revenue growth in 25 years. Revenue growth has been the greatest for corporate taxes and high income individual taxes – both areas where we have substantially increased our enforcement presence in recent years.

In FY 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This is almost 77 percent more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.58 percent in FY 2001 to 0.98 percent in FY 2006.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over $1 million. The number of examinations in the category rose by almost 80,000 as compared to FY 2004, the first year the IRS began tracking audits of individuals with income over $1 million. The coverage rate has risen from 5.03 percent in FY 2004 to 6.30 percent in FY 2006.

Growth in audit totals and coverage rates extend to other taxpayer categories. Preliminary estimates show that the IRS examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over $10 million, examinations rose from 8,718 in FY 2001 to 10,591 in FY 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over $250 million, examinations have increased by nearly 30 percent growing from 3,305 in FY 2001 to 4,289 in FY 2006.

Finally, examinations of tax exempt organizations have also risen. In FY 2001 5,342 tax exempt examinations were closed. This has risen to 7,079 in preliminary FY 2006 numbers.

**The President's FY 2008 IRS Budget Request**

The first step in continuing the progress we have made to improve service and voluntary compliance is approval of the President's FY 2008 budget request for the IRS. That request is for $11.1 billion in appropriated resources and represents a 4.7 percent increase over the FY 2007 House-passed Joint Resolution (JR) level of $10.6 billion.

The request includes $3.6 billion in appropriated resources for taxpayer service and $7.2 billion for enforcement, an increase of 0.9 and 5.8 percent, respectively, over the FY 2007 JR level. This increase includes $56 million in initiatives supporting taxpayer service and $291 million is initiatives supporting enforcement. As in FY 2006 and FY 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The Budget also requests $282 million for Business Systems Modernization. This is a $69 million and 33 percent increase over the level in the House passed Joint Resolution.

If approved, we project that these investments will increase annual enforcement revenue by $699 million dollars a year, once the new hires reach full potential in FY 2010. This does not include the indirect benefits of these investments, which as I will discuss later in my testimony, could be several times the direct return on investment. In addition, we estimate that the legislative proposals for improving compliance that are in the Budget, which I discuss later, will generate $29.5 billion over the next ten years.

In addition to the broad goals of continuing the improvement of service and enforcement, the President's Budget request for the IRS will support a number of initiatives.

***Enhancing Taxpayer Service***

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the Internet, Taxpayer Assistance Centers (TACs), and Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites.

Assisting taxpayers with their tax questions before they file their returns reduces burdensome post-filing notices and other correspondence from the IRS and reduces overall inadvertent noncompliance.

The FY 2008 Budget contains two significant taxpayer service initiatives. First, we are requesting $5 million to expand volunteer income tax assistance. This taxpayer service initiative will help expand the IRS' volunteer return preparation, outreach and education, and asset building services to low-income, elderly, Limited English Proficient (LEP), and disabled taxpayers.

Second, the budget contains a $10 million request to begin implementation of the TAB. As part of the TAB effort, we conducted a comprehensive review of our current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the Blueprint, the funding for this initiative will implement the following telephone service and Web site interaction enhancements:

- *Contact Analytics* provide a tool for evaluating contact center recordings for the purpose of improving understanding of service levels for potential enhancements.
- *Estimated Wait Time* provides a real-time message that informs taxpayers about their expected wait time in queue, allowing them to make more informed decisions based on the status of their call and thus reducing taxpayer burden and increasing customer satisfaction.
- *Expanded Portfolio of Tax Law Decision Support Tools* enables taxpayers to conduct key word and natural language queries to get answers to tax law questions through the Frequently Asked Questions database accessed on IRS.gov, thereby steadily increasing customer satisfaction and operational savings.
- *Spanish "Where's My Refund?"* adds the ability to check refund status to the Spanish Web page on IRS.gov, enabling the Spanish-speaking community to receive the same level of customer service on the web as available to the English Web page.

Continued technological advancements offer significant opportunities for the IRS to improve the efficiency and effectiveness of call center services. Website enhancements are designed to maximize the value of IRS.gov, making the site taxpayers' first choice for obtaining the information and services required to comply with their tax obligations.

***Improving Compliance Activities***

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. We will continue to reengineer our examination and collection procedures to reduce cycle time, increase yield, and expand coverage. As part of its regular examination program, the IRS is expanding the use of cost-efficient audit techniques first pioneered in the National Research Program (NRP).

The IRS is also expanding its efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as nonfilers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

There are six specific initiatives proposed in the FY 2008 Budget aimed at improving compliance. These include:

- Providing $73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance. This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating for possible criminal referral, persons who have evaded taxes. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year, once new hires reach full potential in FY 2010.

- Providing $26.2 million for increasing compliance for large, multinational businesses. This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for noncompliance is significant in the reporting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 to 8.2 percent in FY 2008, and produce over $74 million in additional annual enforcement revenue, once the new hires reach full potential in FY 2010.

- Providing $28 million for expanded document matching in existing sites. This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. We believe the additional resources will result in an increase in AUR closures from 2.05 million in FY 2007 to 2.64 million in FY 2010. We expect $208 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010. In addition, the budget requests $23.5 million to establish a new document matching program at our Kansas City campus. This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this new AUR site should result in over $183 million in additional enforcement revenue per year once the new hires reach full potential in FY 2010.

- Providing $6.5 million to increase individual filing compliance. This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in FY 2008 and produce $82 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010.

- Approving $15 million to increase tax-exempt entity compliance. This enforcement initiative will deter abuse within tax-exempt and governmental entities (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE compliance contacts by 1,700 (6 percent) and employee plan/exempt organization determinations closures by over 9,000 (8 percent) by FY 2010.

- Appropriating $10 million for increased criminal tax investigations. This will help us to aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which includes an emphasis on the fraud referral program. Our robust pursuit of tax violators and the resulting publicity, foster deterrence and enhance voluntary compliance.

In addition to these initiatives, I should stress to you the importance of allowing us to continue with the private debt collection program. The use of private collection agents (PCAs) was authorized by the American Jobs Creation Act of 2004. As we continue to debate the efficacy of this program, I want to take this opportunity to make a couple of points for purposes of our ongoing discussions.

One issue that has been debated is the relative efficiency of using PCAs versus using IRS employees to collect the taxes owed. The most important question is not whether IRS employees or PCAs can do the job more efficiently, but rather whether PCAs collect money that would otherwise go uncollected. The IRS lacks the resources to pursue the relatively simple, geographically dispersed cases that are now being assigned to PCAs. It is not realistic to expect that the Congress is going to give the IRS an unlimited budget for enforcement, and if Congress provided the IRS additional enforcement resources, I believe those resources would be applied best by allocating them to more complex, higher priority cases that are not appropriate for PCAs.

The IRS continues to work with PCAs to ensure that the program is fair to taxpayers and respects taxpayer rights. We currently estimate that between now and FY 2017, our partnership with PCAs will result in approximately 2.9 million delinquent cases receiving treatment that would otherwise have gone unworked. This partnership will help reduce the backlog in outstanding tax liabilities, which has grown by 118 percent over the last 12 years. From September 7, 2006, when cases were first assigned to PCAs, through

December 31, 2006, PCAs collected more than $11 million in net revenue. We estimate that cases worked by PCAs will generate estimated gross revenue of between $1.4. billion through FY 2017.

Another reason to continue to use this tool is to evaluate whether we in the public sector can learn anything from these PCAs that will enable us to do our jobs better. Particularly over the last 20 years, government agencies at all levels have adopted many practices and ways of doing business that have been pioneered in the private sector. One need look no further than the vastly expanded use by the government of the Internet in providing services to the public as an example of a practice that was pioneered in the private sector but adopted quickly and effectively by the government. We should not remove PCAs as a tool for addressing the problem before we have an opportunity to evaluate PCAs' potential to help improve compliance and perhaps even to show the government how to be more effective in its own efforts.

***Reducing Opportunities for Evasion***

The IRS is already aggressively pursuing enforcement initiatives designed to improve compliance and reduce opportunities for evasion. As pointed out earlier, these efforts have produced a steady climb in enforcement revenues since 2001, as well as an increase in both the number of examinations and the coverage rate in virtually every major category.

In the budget request, the Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties in the following ways:

- *Expand information reporting* – Specific information reporting proposals would:

  1) Require information reporting on payments to corporations;
  2) Require basis reporting on sales of securities;
  3) Expand broker information reporting;
  4) Require information reporting on merchant payment card reimbursements;
  5) Require a certified taxpayer identification number (TIN) from non-employee service providers;
  6) Require increased information reporting for certain government payments for property and services; and
  7) Increase information return penalties.

- *Improve compliance by businesses* – Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:

  1) Require electronic filing by certain large businesses;
  2) Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes; and
  3) Amend collection due process procedures applicable to employment tax liabilities.

- *Strengthen tax administration* – The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:

  1) Expand IRS access to information in the National Directory of New Hires database;
  2) Permit the IRS to disclose to prison officials return information about tax violations; and
  3) Make repeated failure to file a tax return a felony.

- *Expand penalties* – Penalties play an important role in discouraging intentional non-compliance. Specific proposals to expand penalties would:

  1) Expand preparer penalties;
  2) Impose a penalty on failure to comply with electronic filing requirements; and
  3) Create an erroneous refund claim penalty.

The Administration also has four proposals relating to IRS administrative reforms.

The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.

The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.

The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding $50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.

The fourth proposal modifies the way that Financial Management Services (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to add the fee to the liability being recovered, thereby shifting the cost of collection to the delinquent taxpayer. The offset amount would be included as part of the 15-percent limit on continuous levies against income**.**

The proposed budget provides $23 million to implement these initiatives. This will fund the purchase of software and the modifications to IRS information technology systems necessary to implement these legislative proposals.

### *Enhancing Research*

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively.

Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line-by-line audits of random samples of returns. This provided us with information on compliance trends and allowed us to update audit selection formulas.

However, this method of data gathering was extremely burdensome on the taxpayers who were forced to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done in 1988.

We conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, until the recent NRP data, all of our subsequent estimates of the tax gap were rough projections that basically assumed no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program, which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 individual returns for Tax Year (TY) 2001. This was less 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 us to meet certain objectives: to estimate the overall extent of reporting compliance among individual income tax filers and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among the major tax gap components since the most recent compliance data were compiled (i.e., 1988 or earlier).

The NRP provided accurate data for determining the sources of noncompliance and for measuring changes in compliance rates over time. The IRS also uses the NRP findings to better target examinations and other compliance activities, thus increasing the dollar-per-case yield and reducing "no change" audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target its resources and effectively provide the best service possible and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts. Research is also critical in helping the IRS to establish benchmarks against which to measure progress in improving compliance.

The FY 2008 Budget would fund two significant research initiatives. First, the budget requests $41 million to improve compliance estimates, measures, and detection of noncompliance. This will fund research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance.

Unlike the past, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This will provide fresh compliance data each year, and by combining samples over several years will provide a regular update to the larger sample size needed to keep the IRS' targeting systems and compliance estimates up to date.

The second research program funded by the request is to research the effect of service on taxpayer compliance. The budget requests $5 million for this project, which will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:

- Meeting taxpayer needs by providing the right channel of communication;
- Better understanding taxpayer burden;
- Understanding taxpayer needs through the errors they make; and
- Researching the impact of service on overall levels of voluntary compliance.

***Continuing Improvements in Information Technology***

Tax administration in the twenty-first century requires improved IRS information technology (IT). We are committed to continuing to make improvements in technology and the FY 2008 Budget reflects that commitment. The FY 2008 Budget requests $81 million to improve the IRS' information technology infrastructure. Sixty million dollars of this amount is requested to upgrade critical IT infrastructure. This infrastructure initiative will provide funding to upgrade the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in FY 2008 include procuring and replacing desktop computers; automated call distributor hardware; mission critical servers; and Wide Area Network/Local Area Network routers and switches.

The other $21 million will be used to enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Finally, the FY 2008 Budget requests a total of $282.1 million to continue the development and deployment of the IRS' Business Systems Modernization program in line with the recommendations identified in the IRS' Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

The development of the CADE (Customer Account Data Engine) and AMS (Account Management Services) systems is the heart of the IT modernization of the IRS. The combination of these two systems working together will enable the IRS to process tax returns and deal with taxpayer issues in a near real-time manner. In fact, our objective is that IRS operate similarly to what one expects from one's bank; account transactions occurring during the business day will be posted and available by the next business day. In addition, AMS will enable the IRS representatives who work with taxpayers to have access to all the information regarding that taxpayer, including electronic access to tax return data, and electronic copies of correspondence. Armed with such comprehensive and up-to-date information, our representatives will be in a much better position to help taxpayers resolve their issues.

MeF is the future of electronic filing. It provides a standard data format for all electronic tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns resulting in a quicker acknowledgement of the filing to the taxpayer or their representative. In FY 2007, the IRS will start development and implementation of the 1040 on the MeF platform, which is expected to take two years.

CSP will provide funding for new portals, which are technology platforms that meet many IRS business needs through Web-based front-ends and provide secure access to data, applications, and services. The portals are mission-critical components of the enterprise infrastructure required to support key business processes and compliance initiatives.

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, the business community, and government, but also contribute to operational improvements and efficiencies within the IRS.

## Implications for the Tax Gap

On September 27, 2006, the Office of Tax Policy in the Department of Treasury forwarded to Congress the outline of a comprehensive strategy to reduce the tax gap. It detailed a seven-prong approach needed to implement a multi-year strategy to reduce the tax gap. Many of the specific elements in our FY 2008 Budget request support this approach.

Put simply, the tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. While no tax system can ever achieve 100 percent compliance, the IRS is committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

It is important to understand, however, that the complexity of our current tax system is a significant reason for the tax gap and that fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions.

### Distinguishing the Tax Gap from Related Concepts

The tax gap is not the same as the so-called “underground economy,” although there is some overlap (particularly in the legal-sector cash economy). The tax gap numbers do not reflect taxes owed on income generated from illegal activities. This makes up a significant portion of the underground economy. However, what we think of as the underground economy does not include various forms of tax noncompliance, such as overstated deductions or claiming an improper filing status or the wrong number of exemptions. These are all included in our calculations of the tax gap.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, even though we do not have the ability to distinguish clearly the amount of non-compliance that arises from willfulness from the amount that arises from unintentional mistakes. We expect future research to improve our understanding in this area.

If all reporting errors were unintentional, we would expect to see a relatively even balance between over reporting and under reporting. However, since taxpayer overstatements of tax appear to be much smaller than understatements of tax, one can reasonably infer that much of the gap is the result of intentional behavior.

### The Most Recent Estimates

The results of the NRP individual income tax reporting compliance study were combined with earlier estimates concerning other taxpayer segments such as corporate taxpayers resulting in an estimate of the overall gross tax gap for Tax Year 2001 of approximately

$345 billion. The net tax gap, or what will remain after enforcement and other late payments, is estimated to be about $290 billion, corresponding to 13.7 percent of estimated total liabilities.

Noncompliance takes three forms: not filing required returns on time (nonfiling); not reporting one's full tax liability when the return is filed on time (underreporting); and not paying by the due date the full amount of tax reported on a timely return (underpayment). We have separate estimates for each of these three types of noncompliance. Underreporting constitutes over 82 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes almost 8 percent and underpayment nearly 10 percent of the gross tax gap.

The individual income tax accounted for about half of all tax receipts in 2001. However, as shown on the chart below, *individual* income tax underreporting was approximately $197 billion or about 57 percent of the overall tax gap. The NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent ($56 billion) of the underreporting gap came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated subtractions from income (i.e., statutory adjustments, non-business deductions, and exemptions) and from overstated tax credits.

**Federal Gross Tax Gap Estimates, Tax Year 2001**

| *Tax Gap Component* | *Gross Tax Gap ($ billions)* | *Share of Total Gap* |
|---|---|---|
| **Individual income tax underreporting gap** | **197** | **57%** |
| Understated non-business income | 56 | 16% |
| Understated net business income | 109 | 31% |
| Overstated adjustments, deductions, exemptions and credits | 32 | 9% |
| **Self-Employment tax underreporting gap** | **39** | **11%** |
| **Corporate and Other Underreporting** | **49** | **15%** |
| **Non-Filers** | **27** | **8%** |
| **Underpayment** | **33** | **10%** |
| **Total Gross Tax Gap** | **345** | **100%** |
| Note: Detail does not add due to rounding | | |

The corresponding estimate of the self-employment tax underreporting gap is $39 billion, which accounts for about 11 percent of the overall tax gap. Self-employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self-employment tax together, we see that individual underreporting constitutes approximately two-thirds of the overall tax gap.

The amounts least likely to be misreported on tax returns are subject to both third party information reporting and withholding, and are, therefore, the most “visible” (e.g., wages and salaries). The net misreporting percentage for wages and salaries is only 1.2 percent.

Amounts subject to third-party information reporting, but not to withholding (such as interest and dividend income), exhibit a somewhat higher misreporting percentage than wages. For example, there is about a 4.5 percent misreporting rate for interest and dividends.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher misreporting percentage of 8.6 percent. As expected, amounts generally not subject to withholding or third party information reporting (e.g., sole proprietor income and the “other income” line on form 1040) are the least “visible” and, therefore, are most likely to be misreported. The net misreporting percentage for this group of line items is 53.9 percent.

**Observations on the Tax Gap**

In the context of the President’s Budget request, I would like to make several observations about the tax gap.

First, while the most recent NRP study did a good job of updating our numbers, we need more research to better identify the sources of non-compliance on a timely and continuing basis.

Second, I think it is well understood that we will never be able to audit our way out of the tax gap. And, while simplification of our tax laws will surely help the vast majority of Americans who already voluntarily comply with those laws, we will actually have to complicate the tax laws to go after the non-compliant taxpayers (e.g., by requiring more information reporting).

Third, we have already made considerable progress in improving compliance as indicated by the steady growth in enforcement revenues in recent years.

Fourth, to reduce the tax gap dramatically will take some draconian steps, ones that will fundamentally change the relationship between taxpayers and the IRS, require an unacceptably high commitment of enforcement resources, and risk imposing unacceptable burdens on compliant taxpayers. Nevertheless, there are reasonable steps, which I have outlined in this statement that can be taken to improve compliance.

**Summary**

The FY 2008 Budget request includes significant increases for IRS enforcement efforts. Fully funding that request will help us make progress in greatly improving compliance.

Based on our analysis covering the most recent 11 years of collection experience, we estimate that every dollar we have spent on enforcement has generated a direct return of an average of four dollars in increased revenue to the Federal Treasury. This return can be expected to occur when the full productive benefit of the investment is realized.

This 4:1 return on investment does not consider the indirect effect of increased enforcement activities in deterring taxpayers who are considering engaging in non-compliant behavior. Econometric estimates of the indirect effects indicate a significant impact from increased enforcement activities. Stated another way, taxpayers who see us enforcing the law against their friends, neighbors or competitors are more likely to comply voluntarily and not risk the chance that we might audit them. We have no means to measure this indirect impact, but research suggests it is at least three times as large as the direct impact on revenue.

Our role is not unlike that of a highway patrolman. He will never be able to ticket every speeder, but he attempts to position himself in areas where he knows that his time is more likely to be spent productively. He also knows that every time he pulls a speeder over, other motorists see that and slow down as well.

We also believe that dollars spent on taxpayer service have a positive impact on voluntary compliance. The complexity of complying with the nation's current tax system is a significant contributor to the tax gap, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of improving voluntary compliance. To this end, the IRS remains committed to a balanced program assisting taxpayers in both understanding the tax law and remitting the proper amount of tax.

In addition, the President's FY 2008 Budget contains a number of legislative proposals that provide additional tools for the IRS to enforce the existing tax law. Perhaps the most critical of these tools is greater third party reporting.

An analysis of the data from the National Research Program of TY 2001individual income tax returns leads to one very obvious conclusion. Compliance is much higher in those areas where there is third party reporting. For example, only 1.2 percent of wages reported on Forms W-2 are underreported. This compares to a 53.9 percent underreporting rate for income subject to little or no third party reporting.

The FY 2008 Budget request asks Congress to expand information reporting to include additional sources of income and make other statutory changes to improve compliance. These legislative proposals are intended to improve tax compliance with minimum taxpayer burden. When implemented, it is estimated that these proposals will generate $29.5 billion over ten years.

I anticipate that some of this year's Budget proposals will be criticized, perhaps because of concerns about their potential impact on small businesses. Our proposals are part of an effort to help small businesses and all other taxpayers pay less by collecting more of the taxes that are owed. In addition, while the information reporting proposals will inevitably impose some burden on compliant taxpayers, they are designed to minimize that burden and to help the IRS better target its audit resources, thereby reducing the number of burdensome audits that result in little or no change to compliant taxpayers' reported liability. The challenges that a small business faces are difficult enough without having to compete directly with noncompliant competitors. We have an obligation to support those compliant small businesses by ensuring that their competitors are also paying their fair share. This is not only a matter of fairness, but also a way of supporting compliant small businesses in their efforts to remain compliant.

Finally, full funding of the budget request will enable the IRS to improve its research with respect to the tax gap. Despite all of our progress, there is still much we do not know about the tax gap. Although the updated estimates provided by the NRP study are more accurate than our previous estimates, and more accurate than the estimates made at various times by others using more indirect methods, they have many limitations.

Tax gap estimates are useful for understanding the general areas and levels of noncompliance and the scope of the problem, but they are far from exact measurements. With the exception of the individual income tax gap, the estimates do not adjust for noncompliance that goes undetected during examination, and estimates are not even available for certain (minor) components of the tax gap.

It is also important to understand that the NRP study looked only at TY 2001 individual income tax returns. The study provided no new information on anything other than the reporting behavior of individual income taxpayers. The data used to estimate corporate compliance and other tax gap components are much older. The estimates are based on data such as the Taxpayer Compliance Measurement Program (TCMP), which we ceased doing in 1988.

To collect more data, we are currently doing an NRP study of reporting compliance of businesses filing Form 1120S (Subchapter S) returns. This involves approximately 5,000 Form 1120S returns from Tax Years 2003 and 2004, taken from a nationwide random sample. This is the first time the IRS has conducted a reporting compliance study across tax years, and it will require that we knit the data together to provide a comprehensive picture. We expect the study to continue through 2007.

Beginning in October 2007, the IRS will begin ongoing annual research activities that will ensure we have the most up to date compliance data possible to measure portions of the tax gap, focus our resources, and improve our audit selection criteria.

While I am confident we have made a significant dent in the tax gap, the lack of current data makes it difficult to quantify exactly how big of a dent has actually been made.

I appreciate the opportunity to testify this morning, and I will be happy to respond to any questions that Members of the Committee may have.