**WRITTEN TESTIMONY OF**
**STEVEN T. MILLER**
**DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT**
**INTERNAL REVENUE SERVICE**
**BEFORE THE**
**HOUSE COMMITTEE ON OVERISIGHT AND GOVERNMENT REFORM**
**SUBCOMMITTEE ON GOVERNMENT ORGANIZATION, EFFICIENCY AND FINANCIAL MANAGEMENT**
**ON THE TAX GAP AND IDENTITY THEFT**
**APRIL 19, 2012**

## INTRODUCTION AND SUMMARY

Chairman Platts, Ranking Member Towns and Members of the Subcommittee on Government Organization, Efficiency and Financial Management, my name is Steven Miller and I am the Deputy Commissioner for Services and Enforcement at the Internal Revenue Service. I appreciate the opportunity to testify on the important issue of the tax gap, and discuss actions that the IRS is taking to improve voluntary compliance with our nation's tax laws. I will also provide the Subcommittee with an update on our identity theft initiatives during the current filing season.

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 system can ever achieve 100 percent compliance, the IRS has been and remains committed to finding ways to increase compliance.

The IRS recently released an updated tax gap study covering the tax year 2006 which shows that the nation's compliance rate for that year of 83.1 percent is essentially unchanged from the last review covering tax year 2001. The report also showed that the net tax gap in dollars for 2006 was $385 billion. (More detailed information on the 2006 tax gap is included in an appendix at the end of this testimony.)

In terms of what makes up the tax gap, the underreporting of business income by individual taxpayers – income of sole proprietors, farmers and those earning rental, royalty, partnership and S Corporation income – is the largest contributor, accounting for $122 billion of the total in 2006. That is because this income, for which little or no reporting is required for income tax purposes, is the least adequately reported.

We at the IRS are often asked what actions we are taking to close the tax gap. I include in my testimony a number of initiatives, from providing taxpayer services to individuals and businesses grappling with a complex tax code, to running targeted compliance and enforcement programs to address a wide variety of compliance issues. But it is important to understand that while the tax gap is a helpful guide to the scale of tax compliance in the economy, it greatly overstates the amount of deficit reduction that could be achieved through IRS enforcement alone. In other words, it is unrealistic to imagine that IRS enforcement revenues, which stood at $55.2 billion for FY 2011, could grow to a level that would close the net tax gap ($385 billion). Further, major attempts to close the gap must be considered within a context that considers taxpayer burden and taxpayer rights.

At the same time, targeted investments in IRS enforcement such as those included in the Administration's FY 2013 budget request have a high return on investment and serve to improve overall compliance. Steady increases in enforcement resources applied to well-founded examination and collection programs, coupled with increases in selected third-party reporting requirements, are proven cost-effective means of reducing the tax gap.

We also should not lose sight of the fact that failures to comply with tax law often involve unintentional mistakes that are the result of not fully understanding what has come to be an extremely complex tax code. For that reason, a truly comprehensive strategy to increase tax compliance must also include programs to educate taxpayers in their tax obligations and efforts at improving customer service, to make it easier for individuals and businesses to fulfill filing requirements.

In its efforts to address the tax gap and improve tax compliance, the IRS follows four guiding principles:

- Both unintentional taxpayer errors and intentional taxpayer evasion should be addressed;
- Sources of noncompliance should be targeted with specificity;
- Enforcement activities should be combined with a commitment to taxpayer service; and
- Policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

Achieving greater voluntary compliance and shrinking the tax gap involves a comprehensive, integrated multi-year strategy. Along with increased enforcement activities, components of this strategy also include: reducing opportunities for tax evasion, expanding compliance research, improving information technology, enhancing taxpayer service, reforming and simplifying the tax law and coordinating with partners and stakeholders, such as states and foreign governments, to share compliance strategies.

The IRS has made considerable progress in these efforts and will continue taking reasonable steps toward this goal as I will detail later in my testimony.

## MEASURING THE TAX GAP

The tax gap statistic is a helpful guide to the scale of tax compliance and to the persisting sources of low compliance but it is not an adequate guide to year-to-year changes. The statistic is also useful in providing the big picture of the relationship between tax liability on the books and tax receipts available to support Federal Government activity, but it should be viewed in the context of a broad range of compliance studies, some of which analyze specific initiatives designed to increase tax compliance.

The tax gap can be viewed in two different ways. There is the gross tax gap, which is simply the amount of true tax liability faced by taxpayers that is not paid on time. For 2006 it is estimated to be $450 billion. The net tax gap of $385 billion represents the amount of true tax liability that is not only not paid on time but is also not collected subsequently, either voluntarily or as the result of enforcement activities. Thus, the net tax gap represents the amount of tax liability that is never paid.

The gross and net tax gap estimates provide only a small portion of the information produced under the tax gap rubric at the IRS. Component tax gap estimates, distinguishing unpaid tax liability by mode of compliance, by tax source and by income source, provide a “map” of where noncompliance is concentrated. Further breakouts, some for specific tax return line items, add additional information.

### *Components of the Tax Gap*

When looked at by mode of compliance, the tax gap can be divided into three components: Nonfiling, or not filing required returns on time; underreporting, or not reporting one’s full tax liability when the return is filed on time; and underpayment, or not paying by the due date the full amount of tax reported on a timely filed return. Underreporting constitutes 84 percent of the tax gap for 2006, while underpayment constitutes 10 percent and nonfiling 6 percent.

The underpayment gap is calculated directly from IRS administrative records for the individual income tax, the corporate income tax, employment taxes, the estate tax and excise taxes. Taxpayers who have filed returns indicating taxes owed but who have not paid the full amounts on time are identified upon filing. The difference between taxes owed as reported on returns and the amounts paid on time is the underpayment gap.

The other two components of the tax gap – nonfiling and underreporting – present vastly greater estimation challenges because they measure activity that is either not revealed to the IRS at all (e.g. failure to file a return) or is reported in understated or otherwise mischaracterized fashion. Estimating those components of the tax gap entails two logical steps: estimating how many taxpayers engage in noncompliant activity and estimating the tax liabilities that they incur but do not report. Those two steps are combined in different ways to estimate the nonfiling and the underreporting gaps.

For example, the figure for the individual income tax nonfiling gap in 2006 was developed using IRS administrative data to identify taxpayers who appeared on a return filed late and taxpayers who did not appear on a return at all. The estimate associated with late returns began with the balance due reported on those returns, but also took into account additional income reported on third-party information documents. The tax on those updated returns was then estimated using a tax calculator. The estimate associated with people who did not file any return followed a similar procedure that also relied on income and withholding reported on third-party information documents.

The predominant method used to calculate the underreporting gap involves auditing a statistically selected sample of taxpayers. Research audits are time consuming, but they constitute the only viable method for estimating the underreporting gap for the individual income tax. This program, called the National Research Program (NRP), has been in place since 2000. The information gleaned from these audits helps examiners more effectively select the types of cases to audit, and offers other detailed insights about noncompliant behavior used throughout the IRS to better target service and enforcement work.

The NRP uses random audits for the underreporting gap and compiles data for the underpayment gap, which is tabulated from the Master File. The NRP office is also involved in nonfiling estimation efforts.

### *Importance of Information Reporting*

One of the key findings from our research on the tax gap has been that tax compliance is far higher when reported amounts are subject to information reporting and, more so, when subject to withholding as well. For 2006, the net misreporting percentage (NMP) – taking the net amount that was misreported and expressing it as a ratio of the true amount – is 1 percent for amounts subject to substantial information reporting and withholding, and 8 percent for amounts subject to substantial information reporting without withholding. But the NMP jumps to 56 percent for amounts, such as business income, that are subject to little or no information reporting or withholding.

These statistics provide further confirmation that “visibility” of income sources and financial transactions is the main factor in high compliance rates, and information reporting is one of the few means of sizably increasing the compliance rate. Therefore, it is significant to note that the predominant source of the tax gap is business income reported on 1040s, which is a much lower “visibility” income source that is not subject to the same information reporting and withholding requirements that exist for salary and wage income.

## IRS ACTIONS TO IMPROVE TAX COMPLIANCE

Since 2001, IRS tax collections have increased significantly, audit rates have improved across all taxpayer segments, and the IRS has expanded its service options. But much work remains to be done, which is why the Administration has called for an increase in funding for the IRS for FY 2013.

The IRS has been and remains committed to improving voluntary compliance, which is the cornerstone of our tax system. The importance of voluntary compliance cannot be overstated: An additional percentage point of voluntary compliance brings in about $25 billion in tax receipts. Therefore, loss of public confidence in the proficiency and fairness of the IRS would come at a high cost, and the effects of a reduction in compliance would take a long time to reverse.

At the same time, the IRS recognizes that increased enforcement alone is not the answer. Put another way, we cannot simply audit our way out of the tax gap. The burden on taxpayers and on IRS resources would be too great. That is why the IRS continues to combine efforts against tax evasion with other measures, such as enhanced research techniques, improvements in information technology, and partnering with stakeholders such as states and foreign governments that also have a vested interest in increased taxpayer compliance.

Following is a description of some of our major initiatives:

- **Return preparers**. The IRS initiated a comprehensive review of the tax return preparation industry in 2009. A multifaceted return preparer strategy was launched in 2010 to ensure top-notch, professional and ethical service to taxpayers. Prior to this initiative, only CPAs, attorneys and Enrolled Agents were subject to professional credentialing, which together represented an estimated 39 percent of paid preparers. As a result of this compliance strategy, which is being phased in over several years; all paid return preparers will be registered with the IRS and identified on the returns they prepare. In addition, all paid preparers who are not CPAs, attorneys or Enrolled Agents will have to pass a competency exam and complete annual continuing education requirements related to tax law and professional conduct. This compliance strategy will cut down on inaccurate and fraudulent returns, help the IRS catch unscrupulous return preparers and improve service to taxpayers so that they are better able to comply with filing requirements.

- **Business taxes**. A major initiative in this area involves business tax audits. In recent years, the IRS has improved its focus in business audits more toward issues with the highest compliance risk. Risk-based audit selection leads to a more efficient use of limited resources and a higher return on investment. The IRS continues to improve its exam selection procedures to focus on the most-pressing issues.

- **Employment taxes**. One of the major ongoing issues the IRS faces in the employment tax area involves companies that misclassify their workers as independent contractors instead of employees, and fail to withhold and remit employment tax on these workers. Last fall the IRS announced a new voluntary worker classification settlement program, which allows companies to voluntarily reclassify workers who have been misclassified. Participating companies get substantial relief from federal payroll taxes they may have owed if they prospectively treat workers as employees. Participants must make a minimal payment covering past payroll tax obligations, but they will not be charged interest or penalties.

- **Basis reporting**. As stated above, third-party reporting and transparency are crucial to a high voluntary compliance rate among individual taxpayers. Basis reporting associated with the buying and selling of securities was an area that was in need of third-party reporting based on previous studies that showed low levels of compliance. The IRS issued proposed regulations in 2009 and final regulations in 2010 under a new law that requires reporting of basis and other information by stockbrokers and mutual fund companies for most stock purchased in 2011 and all stock purchased in 2012 and later years. The reporting will be made to investors and to the IRS.

- **Credit card reporting.** Another major initiative in the area of third-party reporting and transparency involves new merchant card reporting requirements, which were established for the 2011 tax year. They provide third-party reporting data on business receipts for the first time, making it easier for the IRS to identify businesses that are either under-reporting receipts or not reporting at all. In general, these requirements apply to government entities and private businesses, as well as most types of payment cards, such as credit and debit cards. To help ease the transition to this new reporting system, the IRS provided penalty relief to filers for one year, through 2012.

- **Offshore tax avoidance**. Stopping offshore tax cheating and getting these taxpayers, especially high-net-worth individuals, back into the tax system has been a top priority of the IRS. A special offshore voluntary disclosure program was made available in 2009 and again in 2011, and these programs have encouraged more than 33,000 taxpayers to get right with the U.S. tax system while generating billions of dollars in back taxes, interest and penalties. In January, we reopened the special offshore voluntary disclosure program, which will allow us to bring still more taxpayers with offshore accounts into compliance. Offshore tax avoidance is also being addressed through actions against foreign banks that have helped U.S. taxpayers hide their assets. A landmark enforcement victory against a Swiss bank in 2009 has led to the erosion of Swiss bank secrecy, and work by the IRS and the Justice Department continues in this area. There are other international efforts, including the creation of the Global High Wealth unit in November 2009, which was formed to better cope with the growing complexity of income and assets of the high-wealth population.

- **Uncertain tax positions**. In 2011, certain large corporations were required to start making so-called uncertain tax position (UTP) disclosures on their 2010 tax returns. The IRS issued the final UTP Schedule and instructions in September 2010. Reporting of uncertain tax positions fosters compliance by speeding up the time it takes to find issues and complete exams. It also helps the IRS work through corporate returns more efficiently and see where further guidance is needed to reduce uncertainty. An uncertain tax position is generally defined as a stance on a tax return where the corporation sets aside a reserve to either pay the higher amount of tax later or litigate the matter in the future.

- **Real time tax system**. The IRS has started exploring how to implement a series of long-term changes to the tax system which would result in higher levels of tax compliance. Under this concept of a “real time” tax system, the IRS would move away from the traditional “look-back” model of compliance, and instead perform substantially more upfront information return matching with tax returns when they are first filed with the IRS. The goal of this initiative is to improve the tax filing process by reducing burden for taxpayers and improving overall compliance.

- **Refund fraud**. Over the past few years the IRS has seen a significant increase in refund fraud schemes in general and schemes involving identity theft in particular. Overall, the IRS identified and prevented the issuance of more than $14 billion in fraudulent refunds in 2011. Our work in the area of refund fraud is a major endeavor and involves a multifaceted strategy. Our efforts to combat refund fraud related to identity theft are a subset of this program, and further details of what we are doing in this area are outlined below.

- **Earned Income Tax Credit (EITC).** Reducing improper payments in the EITC program is a top priority for the IRS. We have taken a two-pronged approach to dealing with this problem. We perform outreach to help people understand the eligibility requirements before they file a claim. We also have a robust enforcement program that uses a variety of traditional and nontraditional methods. The EITC improper payment rate dropped from 26.3 percent in FY 2010 to 23.5 percent in FY 2011. This corresponds to a reduction in improper payments from $16.9 billion in FY 2010 to $15.2 billion in FY 2011.

- **Nonfilers and underreporters**. Over the last several years, the IRS has enhanced its technology capabilities, including software programs and document matching, to improve our ability to identify cases where taxpayers have failed to file a return or failed to report the correct amount of income. In FY 2011, the IRS closed 4.7 million document matching cases in our Automated Underreporter (AUR) program, up 47 percent from FY 2006. We also closed 1.4 million cases in our nonfiler program, known as Automated Substitute for Return (ASFR) in FY 2011, up 69 percent from FY 2006.

- **Assisting taxpayers**. Along with robust enforcement, a key component of the IRS efforts to shrink the tax gap involves easing burdens on taxpayers to make it easier for them to understand and to pay the taxes they owe. For example, under our Fresh Start initiative, in 2011 and again this year, we added new flexibilities to our collection program. Among other things, these flexibilities give more taxpayers the chance to set up installment agreements or apply for Offers in Compromise (OIC), which in turn allows the IRS to capture more in back taxes than we otherwise would have been able to collect.

- **Improvements in compliance research**. Keeping track of noncompliance in the presence of changing tax law and changing economic conditions, and conducting research on ways to increase compliance, are top priorities at the IRS. Research that is produced out of the NRP directly informs the models and algorithms that the IRS uses to target resources to the areas of highest compliance risk.

## IDENTITY THEFT UPDATE: 2012 FILING SEASON

As I stated above, the IRS has seen a significant increase in refund fraud schemes in general and schemes involving identity theft in particular. The IRS has a comprehensive identity theft strategy that comprises a dual effort, focusing both on fraud prevention and victim assistance. Following up on my testimony to the Subcommittee in November on identity theft, I would like to provide the Subcommittee with an update on IRS actions taken recently to improve our efforts against identity theft for the 2012 filing season and beyond.

### *Preventing Fraud from Identity Theft*

Since 2008, the IRS has marked the accounts of more than 460,000 taxpayers who appear to have had their identities stolen outside the tax system. These are taxpayers who have filing requirements and who are or may be impacted by the theft. With respect to these taxpayers, in calendar year 2011, the IRS protected $1.4 billion in refunds from being erroneously sent to identity thieves. This does not include identity theft of those without a filing requirement (though that value is also included in the figure cited above of $14 billion in fraudulent refunds prevented in 2011).

The IRS is committed to improving its approaches to blocking these fraudulent refund claims. To that end, we strive to process returns in such a way that potentially false returns are screened out at the earliest possible stage. For example:

- Various new identity theft screening filters have been put in place to improve our ability to spot false returns before they are processed and before a refund is issued. For example, new filters were designed and launched that flag returns if certain changes in taxpayer circumstances are detected. As of March 9, 2012, we have stopped 215,000 questionable returns with $1.15 billion in claimed refunds from filters specifically targeting refund fraud.

- Moreover, this filing season we have expanded our work on several fraud filters which catch not only identity but other fraud. In this area we have stopped roughly as much so far this filing season as we stopped last calendar year. Until we work these cases we will not have a solid answer as to how much of this work is fraud but not identity fraud, but we suspect a great deal may fall into the latter category.

- We have implemented new procedures for handling returns that we suspect were filed by identity thieves. Once a return has been flagged, we will correspond with the sender before continuing to process the returns.

- We have accelerated the availability of information returns in order to identify mismatches earlier, further enhancing our ability to spot fraudulent tax returns before they are processed.

- We are leveraging mechanisms to stop the growing trend of fraudulent tax returns being filed under deceased taxpayers' identities. We have coded accounts of decedent taxpayers whose Social Security numbers were previously misused by identity thieves to prevent future abuse. We are also identifying returns of recently deceased taxpayers to determine if it is the taxpayer's final return, and then marking accounts of deceased taxpayers who have no future filing requirement. So far this filing season, 66,000 returns have been stopped for this review.

- We expanded the use of our list of prisoners to better utilize the list to stop problematic returns. We have stopped 135,000 questionable returns this filing season. For the fiscal year, we have prevented almost $800 million in refunds. This represents an 80% increase in refunds stopped over the same period last year.

### *Criminal Investigation Work*

The investigative work done by our Criminal Investigation (CI) division is another major component in our efforts to combat tax-related identity theft. Recent actions taken by CI in the identity theft area include the following:

- We established the Identity Theft Clearinghouse (ITC), a specialized unit that became operational in January, to work on identity theft leads. The ITC receives all refund-fraud-related identity theft leads from IRS-CI offices. The ITC's primary responsibility is to develop and refer identity theft schemes to the field offices, facilitate discussions between field offices with multi-jurisdictional issues, and provide support for ongoing criminal investigations involving identity theft.

- We have continued to increase investigations of tax fraud related to identity theft. Already in Fiscal Year 2012, CI has initiated 258 cases and recommended 150 cases for prosecution. Indictments in identity theft cases total 167, with 49 individuals sentenced and average time to be served at 45 months. The direct investigative time spent on identity theft in FY 2011 was 225,000 hours, and CI is on pace to double this in FY 2012.

- We conducted a coordinated identity theft enforcement sweep, which occurred during the week of January 23. It was an outstanding success. Working with the Justice Department's Tax Division and local U.S. Attorneys' offices, the nationwide effort targeted 105 people in 23 states. The coast-to-coast effort that took place included indictments, arrests and the execution of search warrants involving the potential theft of thousands of identities. In all, 939 criminal charges were included in the 69 indictments and informations related to identity theft. That same week, IRS auditors and investigators conducted extensive compliance visits to money service businesses in nine locations across the country. The approximately 150 visits occurred to help ensure that these check-cashing businesses aren't facilitating fraud and identity theft.

### *Assisting Taxpayers Victimized by Identity Theft*

Along with prevention, the other key component of the IRS' efforts to combat identity theft involves providing assistance to taxpayers whose personal information has been stolen and used by a perpetrator in the tax filing process. We are implementing new procedures designed to resolve cases faster and minimize the disruption to innocent taxpayers. We increased staffing last year and this year, and have plans to dedicate additional resources following the current filing season. By the end of the fiscal year, staffing dedicated to identity theft will be almost 2,500 employees.

In 2011 we launched a pilot program for Identity Protection Personal Identification Numbers (IP PIN). The IP PIN is a unique identifier that establishes that a particular taxpayer is the rightful filer of the return. Under this pilot, we issued IP PINs to more than 50,000 taxpayers who were identity theft victims. We have expanded the program for the new filing season, and have issued IP PINs to approximately 250,000 taxpayers who have suffered identity theft in the past.

To ensure that we provide high quality, courteous service to taxpayers who have been victims of identity theft, last year we conducted a thorough review of the training we provide our employees. We wanted to make sure that they have the tools and the sensitivity they need to respond in an appropriate manner to taxpayers in these situations. Out of this review, we did two things:

- We updated the training course for our telephone assistors in order to ensure that our assistors maintain the proper level of sensitivity when dealing with identity theft victims and understand the serious financial problems that identity theft poses for these taxpayers. We conducted this training at the beginning of the 2012 filing season.

- We broadened the scope of our training to cover those IRS employees who are not telephone assistors but who nonetheless interact with taxpayers or work identity theft cases. We developed a new course for these employees, which includes not only sensitivity training but also ensures that employees who process identity theft cases have the proper tools and techniques to do so. This course was provided to all employees who might come into contact with an identity theft victim. In all, 35,000 IRS employees received this training.

## CONCLUSION

Mr. Chairman, thank you again for the opportunity to appear before the Subcommittee to discuss the tax gap and to provide you with an update on IRS actions taken in the area of identity theft. The IRS remains committed to finding ways to increase compliance and thus reduce the tax gap, while minimizing burden on the vast majority of taxpayers who pay their taxes fully and on time. On the issue of identity theft, our work here for filing season 2012 is a solid start but not the end of our efforts. I cannot tell you that we will beat this problem in one year. I can tell you we have committed our talents and resources to prevent the issuance of fraudulent refunds and have developed processes to minimize the pain felt by those who have been victimized. We are committed to continuing to look for new and innovative ways to improve our processes and techniques. I would be happy to answer any questions you may have.

**STEVEN T MILLER**

**DEPUTY COMMISSIONER FOR SERVICES & ENFORCEMENT**

Steven T. Miller is Deputy Commissioner for Services and Enforcement, providing direction and oversight for all major decisions affecting the four taxpayer-focused IRS Divisions: Wage and Investment, Large and Mid-Size Business, Small Business/Self-Employed, and Tax Exempt and Government Entities. He also provides the executive direction and leadership for the IRS Criminal Investigation Division, which investigates income tax evasion and related financial crimes; the IRS Office of Professional Responsibility, which administers the laws and regulations governing the practice of tax professionals before the IRS; and the IRS Whistleblower Office, which receives information on tax cheating and provides appropriate rewards to whistleblowers.

Prior to his appointment as the Deputy Commissioner for Services and Enforcement, Steve served as the Commissioner of the Large and Mid-Size Business Division. In this position, he had oversight for federal tax administration for domestic and foreign corporations and partnerships with assets of $10 million or more that have a United States tax filing requirement. Previously, as the Commissioner of the Tax Exempt and Government Entities Division, Steve oversaw the administration of tax law relating to employee plans, tax-exempt organizations and various government entities. Steve also served as the Director of Exempt Organizations and as the acting Assistant Commissioner and Special Assistant to the Assistant Commissioner, Employee Plans/Exempt Organizations. Other prior service includes several years in Chief Counsel, serving as a Congressional staff member for the Joint Committee on Taxation and work in private practice.

Steve graduated with a Bachelor of Arts degree from the University of Maryland, a Juris Doctor degree from George Washington University, and a Master of Laws degree in taxation from Georgetown University Law School.