S. HRG. 109–1004

A CLOSER LOOK AT THE SIZE AND SOURCES OF THE TAX GAP

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

JULY 26, 2006

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A CLOSER LOOK AT THE SIZE AND SOURCES OF THE TAX GAP

WEDNESDAY, JULY 26, 2006

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:04 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Jon Kyl (chairman of the subcommittee) presiding.

Present: Senators Jeffords and Lincoln.

Also present: Philip Shropshire, Office of the Treasury Inspector General for Tax Administration.

OPENING STATEMENT OF HON. JON KYL, A U.S. SENATOR FROM ARIZONA, CHAIRMAN, SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT, COMMITTEE ON FINANCE

Senator KYL. This hearing will come to order.

This is a hearing of the Senate Finance Committee's Subcommittee on Taxation and IRS Oversight titled, "A Closer Look at the Size and Sources of the Tax Gap."

The full Finance Committee held a hearing in 2005 on the tax gap, that is, the difference between what the U.S. taxpayers owe and what the U.S. Treasury actually receives.

The Budget Committee held a similar hearing earlier this year. Today's hearing is designed as a follow-on to those hearings and will take a much closer look at the tax gap. We will consider its size, and what causes it to exist.

Chairman Grassley and Senator Baucus have asked the Treasury Department and the Internal Revenue Service to develop a strategy for addressing the tax gap. If members of this committee are going to evaluate any such strategy, I believe we need to have a more comprehensive understanding of the problem.

That is the purpose of this hearing, to give Senators on this committee an opportunity to learn more about the tax gap so that we can make better decisions when we are presented with legislative proposals designed to improve tax compliance.

Like revenue estimates produced by other government number crunchers, the tax gap is an estimate. But if Congress is going to push the IRS to reach a voluntary taxpayer compliance target, we need to know how good the estimate is, and we need an understanding of where it could, and should, be improved. We also need to understand what data might be too difficult to collect without imposing unreasonable burdens on taxpayers.

In addition to understanding the numbers, we also need to consider where the current system is failing, what can be done to address those failures, and how efforts to improve tax compliance will affect taxpayers.

In preparing for this hearing, we asked the witnesses to consider where current IRS enforcement practices are falling short and whether additional resources would improve compliance enough to justify the expense.

We asked whether current enforcement tools are sufficient or if additional tools, such as increased information reporting or withholding, would be appropriate.

Finally, we asked the witnesses to consider the extent to which the tax system itself, with its mind-boggling complexity and special targeted tax benefits, contributes to the tax gap.

This last point, the need for tax simplification, may be the most reasonable way to address the tax gap. I know the Chairman of this committee is pressing forward on tax reform, and I expect that simplifying our tax system and improving compliance will be critical to that effort.

Most Americans are responsible, honest, and hardworking, and we should not assume they are falling short in their tax obligations on purpose. A more simple and straightforward tax system will reduce compliance costs and make it easier for Americans to pay the taxes they owe.

Now, before I identify who our witnesses are and introduce them, let me turn to our Ranking Senator, Mr. Jim Jeffords.

OPENING STATEMENT OF HON. JAMES M. JEFFORDS, A U.S. SENATOR FROM VERMONT

Senator JEFFORDS. Thank you, Mr. Chairman. I want to commend you for holding this hearing today on the tax gap. I also want to recognize the efforts of Chairman Grassley, and especially Senator Baucus, in calling attention to this issue over the years.

Even more important than talking about the problem, of course, is taking action to fix it. I look forward with great interest to the plan of action we will be receiving from the administration in the next few months.

I have to say, I am not sure that this has been a very high priority with the administration. When I checked last week, we were still awaiting answers from the administration to questions we posed at our April 2005 hearing on the tax gap.

In Congress, there is plenty of the responsibility as well. We have had lots of good recommendations for years from several sources, including many of today's witnesses, but have yet to act on any of them.

I hope that, with continued efforts to shed light on this problem, we can build support for taking concrete steps to attack it.

As Ms. Olson pointed out last year, the average tax return includes a tax gap "surtax" of $2,000 each year. We need to get that number as close to zero as we possibly can.

Mr. Chairman, thank you again for calling today's hearing. My thanks as well to the witnesses for their willingness to help us, and their work day-in and day-out on this very vital issue. It is a pleasure to be with you all, and I look forward to hearing you.

Senator KYL. Thank you, Senator Jeffords.

Our panelists are really the experts. We have Dr. Mark J. Mazur, who is Director of Research, Analysis, and Statistics with the Internal Revenue Service; Mr. Michael Brostek, Director of Tax Issues, Strategic Issues Team, Government Accountability Office; the Honorable J. Russell George, Inspector General for Tax Administration, U.S. Treasury; Ms. Nina Olson, National Taxpayer Advocate, Taxpayer Advocate Service; and Hon. Raymond T. Wagner, Jr., Chairman of the IRS Oversight Board and legal and legislative vice president, Enterprise Rent-A-Car Company.

As I say, we are blessed to have some real experts here, and we very much look forward to your testimony. I think, probably, in the order that I read the witness names and I believe you appear on the dais, would be the proper order for you to make your presentations, so please feel free to do so at this time.

STATEMENT OF DR. MARK J. MAZUR, DIRECTOR, RESEARCH, ANALYSIS, AND STATISTICS, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Dr. MAZUR. Thank you, Chairman Kyl and Senator Jeffords. I am pleased to be here today to talk about the tax gap. I ask that my entire statement be entered into the record.

Senator KYL. All statements will be entered.

Dr. MAZUR. Thank you.

[The prepared statement of Dr. Mazur appears in the appendix.]

Dr. MAZUR. My remarks today are going to focus on the tax gap numbers themselves, as well as the methodology used to arrive at those numbers.

As Chairman Kyl said, the tax gap is the difference between the amount of tax imposed on taxpayers for a given tax year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of non-compliance with our tax laws.

Historically, our estimates of compliance were based on what we call the Taxpayer Compliance Measurement Program, or TCMP. That consisted of line-by-line audits of returns from randomly selected taxpayers. This provided IRS with information on compliance trends. It also provided IRS with information to update audit selection formulas.

However, the TCMP method of accumulating data was very burdensome on taxpayers and, as a result of concerns raised by taxpayers, Congress, and other stakeholders, the IRS discontinued those TCMP audits with tax year 1988.

The IRS has conducted some narrow studies since then, but nothing really gave us a comprehensive perspective on the overall tax gap. The National Research Program came into being in 2000–2001, and that is being used to estimate the tax gap more recently.

We tried to develop a less intrusive way of coming up with measures of tax compliance. For example, on the individual reporting compliance study that we have done, we used a focused, statistical sample that had fewer returns in the sample than in the previous 1988 study, even though there were more tax returns filed in tax year 2001.

We think the NRP approach allows us to estimate the overall extent of reporting compliance at lower burden costs to taxpayers. We are getting about the same high quality of data, with less burden on taxpayers.

Part of this is because we have a couple of innovations in the way we do the NRP audits. One is what we call case building. It allows us to take information from prior year returns, information documents, third party documents, and put that together in a case file for the taxpayer's return.

That gives the examiner a sense of what they could look at in the return. It also prevents the examiner from asking burdensome questions of taxpayers on documents the IRS already has, for instance, "Where is your W–2?" Well, we already have that.

The second innovation from the NRP was to set up a classification procedure, where an experienced examiner went through the case file and decided where to focus the examination. Some of the returns an experienced examiner could look at and say, these are plausibly compliant. We did not need to contact the taxpayer at all and could kind of put them aside. Some, we could designate for correspondence audits for one or two issues that needed to be verified, and others had to go to a face-to-face audit. Both of these innovations allowed us to reduce the burden on taxpayers.

One thing that we want to focus on for the tax gap numbers—and the chart behind me lays out the estimate for tax year 2001—the overall tax gap, we estimate for tax year 2001, is about $345 billion.

That corresponds to a non-compliance rate of about 16.3 percent. After the amounts that are collected from late payments and through enforcement, we estimate the net tax gap is around $290 billion a year.

On the chart, you can see that non-compliance takes three forms: non-filing, under-reporting, and under-payment of tax liability.

Under-reporting accounts for about 82 percent of the gross tax gap, non-filing around 8 percent, and under-payments around 10 percent of the tax gap. Individual income tax under-reporting accounts for about $197 billion, or about 56 percent of the overall tax gap.

As in previous compliance studies, the data we have suggest that about half, or well over half, of the individual under-reporting gap comes from understated net business income.

Approximately 28 percent comes from under-reported non-business income—wages, interest, dividends, and so on—and about $32 billion comes from overstated subtractions from income, exaggerated deductions, or misstated tax credits.

If you add in the under-reporting on self-employment tax, that is another 11 percent or so of the tax gap. So taken together, the individual income tax and the self-employment tax, we have about two-thirds of the overall tax gap accounted for in those two buckets.

One of the things that becomes apparent when you look at the data is that the amounts that are most likely to be reported correctly on returns are those where there is third party information reporting and where there is withholding. So, for instance, wages and salaries have about 1 percent misreporting.

On the other hand, things that are not reported by third parties and not withheld tend to have the highest misreporting. For instance, business income may be misreported about 50 percent.

On the tax gap map chart, the colors are used to indicate the amount of confidence we have in the estimates. The blue ones are where we have a high degree of confidence, the green ones are where we have actual data or accounting data, and the yellow ones are for weaker estimates.

The corporate income tax estimates, in particular, are areas where we have not done an update of the studies in quite a while, so those estimates are, to a large degree, weaker than the ones for individual income tax.

Right now, we are undertaking a reporting compliance study of S corporations. This is the first time the IRS has done this kind of study since 1984. Back in those years, there were about 700,000 S corporations; now there are more than 3 million.

So, S corporations are more prevalent than ordinary Schedule C corporations that pay corporate income tax, and we know very little about their behavior. That is why we chose this as the second study that we undertook as part of the National Research Program Reporting Compliance Study Program.

Future reporting compliance studies will be undertaken. Our idea is to go through the various boxes on the tax gap map and get an understanding of all those different types of misreporting. Obviously, the constraint we have at the IRS is the amount of enforcement resources that we need to devote to those studies.

Let me just conclude, quickly, by saying that a nearly 84-percent voluntary compliance rate for the tax system is a good one. Internationally, this puts us in a good position. It is something that we should be proud of. Obviously, we can do better. We can reduce that 16 percent misreporting gap to some smaller number and benefit all taxpayers.

I want to mention, we got a lot of support from the committee and the staff in developing these studies, and we do appreciate the support we have gotten from you.

Thank you for the opportunity to discuss the tax gap today.

Senator KYL. Thank you, Dr. Mazur.

Mr. Brostek?

STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX ISSUES, STRATEGIC ISSUES TEAM, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. BROSTEK. Mr. Chairman, Senator Jeffords, I am pleased to participate in today's committee hearing on approaches for reducing the tax gap.

My statement will focus on potential reductions in the tax gap that could ensue from simplifying or reforming the code, providing IRS more tools, and dedicating more resources to tax enforcement.

In summary, the tax gap is a persistent problem, and, as the saying goes, we will keep on getting the same result, an unacceptable tax gap, if we keep on doing the same things. We need to try new approaches or make greater use of current effective approaches.

While simplification, more tools, and more resources all do have potential to help reduce the tax gap, multiple approaches are likely

to be the most effective strategy. No one strategy is likely to fully and cost-effectively reduce the tax gap.

In determining a strategy to pursue, key factors to consider include, as Dr. Mazur was saying, periodically measuring non-compliance and its causes, setting reduction goals, leveraging technology, optimizing IRS resource allocations, and evaluating the results of any initiatives taken. An effective, well-supported strategy has the potential to reduce the tax gap by many billions of dollars.

In terms of simplification or reform, there is no reliable estimate of the degree to which simplification could reduce the gap. One indication of the potential is that IRS estimated a revenue shortfall of about $32 billion occurred in 2001 due to errors that taxpayers made in claiming credits and deductions.

Over the decade, the tax code has layered on more and more special tax provisions, with the number of these so-called tax expenditures doubling in number between 1974 and 2005.

By making rules more uniform across tax provisions, by merging multiple related tax provisions, and by deleting provisions that may not be accomplishing their intended purpose at an acceptable revenue cost, the tax code could be simplified. Both intentional and unintentional errors by taxpayers should decline with simplification.

Further, to the extent that simplification reduces errors, IRS should be able to reallocate its resources to other, more problematic areas of the code, giving you sort of a "two-for" from simplification. However, each tax code provision was created to address an issue that Congress had determined to be important and, thus, simplification can be challenging.

Tax reform also has the potential to reduce the tax gap, but it is most likely to have that result if any reform system has few, if any, exceptions to it and few complex provisions, and any taxable transactions are transparent to the tax agency. These characteristics, however, are difficult to achieve, and, as suggested by Mr. Mazur, to my knowledge all tax systems have tax gaps.

Tax withholding and information reporting are among the most powerful tools for promoting compliance. If we can spread these tools to cover more types of income that are major contributors to the tax gap, substantial tax gap reductions might be achieved.

Our recent work suggests that requiring information reporting on the basis for security sales like stock transactions has the potential to improve compliance with capital gains reporting. Importantly, a key additional benefit of these tools would be less taxpayer burden to understand and comply with the basis reporting requirements.

Additional opportunities for withholding or information reporting exist for payments made to independent contractors and for payments made to corporations for services that they provide to other corporations.

Finally, devoting additional resources to enforcement has the potential to reduce the tax gap by billions of dollars. I would be remiss not to point out, however, that a balanced approach of providing services to help taxpayers comply, along with enforcement where that is the best approach, is essential for making balanced progress against the tax gap.

Nevertheless, devoting greater resources to enforcement could reduce the gap, since every year IRS identifies far more cases of probable non-compliance than it can address.

How much the tax gap could be reduced by dedicating more resources to enforcement depends critically on how well IRS can manage those resources. Here, information is key. Which taxpayers are non-compliant? Why are they non-compliant? What amount of non-compliance can be corrected for each additional investment in IRS enforcement programs? We, and others, have frequently called for improved information like this to ensure sound management of IRS's limited resources.

In part, this is why we encouraged IRS to undertake compliance studies like NRP, and why we believe that continuing regular compliance studies is a priority.

As a caution, if additional resources are devoted to enforcement, returns on that investment are likely to lag some as IRS uses the additional resources, by hiring staff, training them, and putting them on line.

This concludes my oral statement. I would be happy to answer any questions.

Senator KYL. Thank you, Mr. Brostek.

[The prepared statement of Mr. Brostek appears in the appendix.]

Senator KYL. Now, Mr. George?

STATEMENT OF HON. J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, WASHINGTON, DC

Mr. GEORGE. Thank you, Mr. Chairman.

Chairman Kyl, Senator Jeffords, thank you for the invitation to discuss the size and sources of the tax gap, and opportunities for reducing it.

This year, the IRS updated its previous estimate of the tax gap, which had been based on data from 1988. The new estimates is based on individual income tax returns for the 2001 tax year.

Despite this significant effort, the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and voluntary compliance rate.

The updated information on individual wage earners is an improvement because they comprise the largest segment of taxpayers. However, there is no new information about employment, corporate, and other taxpayer segments.

With no firm plans to update the study for these segments, we will be left with an unfinished picture of the tax gap and compliance rate. Without this information, comprehensive attempts to successfully address the tax gap may be for naught.

One area that could significantly impact the tax gap involves third party reporting. The difference in compliance rates between individual wage earners and those operating businesses is striking.

The IRS has estimated that compliance rates are as high as 96 percent when third party reporting is involved. In contrast, self-employed individuals are estimated to report only about 68 percent of their income. Even more alarming, it is estimated that self-

employed individuals operating on a cash basis are reporting just 19 percent of their income.

Each year, under-reporting by individuals with business income accounts for over 40 percent, or approximately $130 billion, of the total tax gap. Three years ago, TIGTA recommended that the IRS initiate a proposal for a legislative change to mandate withholding on non-employee compensation payments. Implementing such a provision could reduce the tax gap by billions of dollars.

IRS compliance efforts are also limited by the lack of available information on the cost basis of investments, which could be used to verify investment gains or losses. Such information would allow the IRS to better focus its enforcement resources on non-compliant taxpayers.

TIGTA has also reported on issues relating to the global economy. Investments made abroad by U.S. residents have nearly tripled in recent years, growing from $2.6 trillion in 1999 to $7.2 trillion in 2003. To address the tax compliance challenges presented by these investments, TIGTA has recommended that the IRS make better use of foreign-source income information.

We have also recommended that, prior to issuing refunds to citizens of foreign countries, the IRS should confirm that the amount of withholding being claimed is valid.

Finally, I would like to address the resources available to the IRS. Over the last decade, the number of IRS enforcement personnel declined from approximately 22,000 at the beginning of 1996, to roughly 14,000 at the end of 2005, amounting to a 35-percent decrease.

Even though the IRS has started to reverse many of the downward trends in compliance activities, the enforcement staffing level is not much higher today than the 10-year low it experienced in the year 2003.

Additional resources might help the IRS address the growth of fraudulent returns being filed by incarcerated people. Last year, I testified before the House Ways and Means Committee about this problem.

Refund fraud committed by prisoners was growing at an alarming rate. The number of fraudulent returns filed by prisoners and identified by the IRS grew from 4,300 in processing year 2002 to more than 18,000 in 2004—a 318-percent increase.

It is unlikely that a massive change in voluntary compliance can be achieved without significant changes to the tax system. Strategies have been identified to decrease this tax gap, and improvements can be realized.

However, without significant resources, the IRS faces formidable challenges in accurately estimating the tax gap and finding effective ways to increase compliance.

Mr. Chairman, Senator Jeffords, I appreciate the opportunity to share my views on the tax gap and the work TIGTA has done in this area. I would be happy to answer any questions you have at the appropriate time.

Senator KYL. Thank you, Mr. George.

[The prepared statement of Mr. George appears in the appendix.]

Senator KYL. Ms. Olson?

STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, TAXPAYER ADVOCATE SERVICE, WASHINGTON, DC

Ms. OLSON. Mr. Chairman and Senator Jeffords, thank you for inviting me to testify today.

At the outset, let me suggest that the ultimate question we should be focused on is not, "How do we reduce the tax gap?" but rather, "How can we increase voluntary compliance?"

This is so because voluntary compliance, as opposed to enforced compliance, creates taxpayers who are willing to work with the tax system rather than taxpayers who hide from the tax system. Moreover, in the long run, voluntary compliance is the most cost-effective way to achieve lasting compliance.

To determine how to allocate its resources most effectively to increase voluntary compliance, the IRS needs to do a better job of understanding the reasons why the tax gap exists.

At the risk of over-simplifying matters, let me suggest that we consider three types of taxpayers: (1) taxpayers who will go to great lengths to comply with whatever requirements exist; (2) taxpayers who view taxes as one of the many burdens they face in everyday life, and who will comply only if doing so is straightforward and not time-consuming; and (3) taxpayers who willfully seek to evade their tax obligations.

What percentage of taxpayers fall into each of these three categories? It is impossible to know with precision. But the IRS has information that indicates the majority of taxpayer errors are attributable to inadvertent error rather than intentional non-compliance.

When IRS auditors conducted approximately 46,000 audits of individual taxpayers for purposes of the National Research Program, the auditors were asked, for each issue they identified, to characterize the reason for non-compliance. The results were striking.

Among issues IRS auditors examined that resulted in a change in a tax liability, the auditors listed 67 percent as inadvertent mistakes; 27 percent as computational errors or errors that flowed automatically; and only 3 percent of the errors as intentional.

A recent GAO study on capital gains misreporting also suggests that deliberate cheating is responsible for significantly less than half of all reporting inaccuracies. Despite these data, I am concerned that the IRS has been proceeding on a course that emphasizes stepped-up enforcement over stepped-up taxpayer service.

The high percentage of inadvertent errors underscores the need to go beyond classifying taxpayers simplistically as honest or dishonest, and to develop solutions to improve compliance more generally through an approach that includes components of both taxpayer service and enforcement.

The IRS needs better research to determine the most effective use of its resources, after taking into account both the direct and indirect effects of its activities on tax revenue. In most cases, the indirect effects are probably greater than the direct effects.

Moreover, it should not be a question of service or enforcement. The IRS should integrate taxpayer service within its enforcement activities. Particularly in light of its limited resources, the IRS should focus its enforcement activities not merely on collecting

taxes that were not paid in the past, but also on trying to bring taxpayers into compliance prospectively.

In my view, the IRS could also do a better job of going where the money is. As Dr. Mazur described, that means the cash economy. The NRP data indicate that, where taxable payments are reported to the IRS by third parties, reporting compliance comes to roughly 96 percent of the tax due. But where taxable payments are not reported to the IRS by third parties, reporting compliance drops below 50 percent.

In my annual reports to Congress and in my previous Congressional testimony, I have offered numerous proposals to help the IRS do a better job at combatting the cash economy portion of the tax gap. Some of those proposals are summarized in the appendices at the end of my written statement.

Even though the IRS can do more to improve voluntary compliance, I do not believe the compliance rate will rise dramatically unless Congress passes legislation to make it easier for the IRS to detect non-compliance, primarily through expanded third party information reporting or withholding.

Congress could also improve compliance by facilitating easier payments of estimated tax, improving the offer-in-compromise program, and strengthening standards in the tax return preparation industry. Tax simplification would help enormously as well.

In conclusion, to reduce the tax gap, Congress and the IRS must focus on ways to increase voluntary compliance with the tax code. There is no one-size-fits-all solution.

Through an effective combination of improved education, outreach and assistance, and targeted enforcement action, the IRS can improve voluntary compliance. But to make a real dent in the problem, Congress must act. It must increase the transparency of cash economy transactions through expanded third party information reporting and withholding, and Congress should simplify the tax code to make it easier for taxpayers to comply with its requirements.

Thank you.

Senator KYL. Thank you, Ms. Olson.

[The prepared statement of Ms. Olson appears in the appendix.]

Senator KYL. We will conclude with Mr. Wagner.

STATEMENT OF HON. RAYMOND T. WAGNER, JR., CHAIRMAN, IRS OVERSIGHT BOARD, WASHINGTON, DC; AND LEGAL AND LEGISLATIVE VICE PRESIDENT, ENTERPRISE RENT-A-CAR COMPANY, ST. LOUIS, MO

Mr. WAGNER. Thank you, Mr. Chairman.

Chairman Kyl, Ranking Member Jeffords, members of the subcommittee, I am Raymond T. Wagner, Jr., Chairman of the IRS Oversight Board. Thank you for the opportunity to appear this afternoon.

You have already heard from a full panel today, and therefore I would like to summarize my written testimony, which shall be included in the record.

[The prepared statement of Mr. Wagner appears in the appendix.]

Mr. WAGNER. I would like to focus my remarks on how to apply a broad set of strategies to reduce the gap. Considering the Board's

role in providing strategic governance to the IRS, I think describing effective strategies is the right role for the Board.

Despite significant improvements in IRS operations in the past 6 years, the tax gap, because of its size and its persistence, is one of the most serious problems facing tax administrators in the country today.

Our tax administration system starts with the expectations that taxpayers will comply voluntarily with tax laws. In fact, in 2005, taxpayers paid about $2 trillion annually. However, some taxpayers do not pay what they owe voluntarily, and that is why we have an annual gross tax gap of $345 billion.

The IRS tries to recover what it can through enforcement actions, but only a fraction of the gap is recovered that way, as you have heard. In 2005, enforcement revenues were about $47.3 billion, leaving a net tax gap of around $295 billion.

Let me summarize, simply, why the tax gap is offensive. It is fundamentally unfair for honest taxpayers to carry the load for those who cheat, it deprives the government of revenues to which it is entitled, and it undermines the confidence that honest taxpayers need to have in our system if they are to continue to be honest.

Let me also make some general statements about fixing the gap. We know how to reduce the gap, but we have trouble doing it. Every organization sitting at this table has made effective recommendations in the past on how to reduce it. Implementing the recommendations is much more difficult than articulating them.

On the other hand, there is no one, single silver bullet that can be implemented that will solve the problem. What is needed is a comprehensive set of strategies with action on many fronts.

The tax code is getting more complex every year, and determining one's correct tax obligation is hard, and getting harder under the growing complexity of the code, which in turn hurts voluntary compliance. This relationship should be self-evident.

Voluntary compliance is far superior to enforcement. We collect $2 trillion voluntarily, and less than $50 billion through enforcement, but roughly half of the IRS budget is for enforcement. There is no doubt which is better.

In the words of Ben Franklin, "An ounce of prevention is worth a pound of cure." Effective strategies are needed to influence taxpayers to file and pay what they owe voluntarily. Lastly, additional IRS resources do pay for themselves.

Let me now turn my attention to describing six strategies that can effectively reduce the tax gap, many of which you have heard already this afternoon.

The first recommendation is to simplify the tax code. Complexity has three serious consequences: it makes it difficult for honest taxpayers, it gives aid to those who want to cheat, and it makes it hard for the IRS to identify non-compliance.

Second, taxpayers who have their income reported to the IRS are much more compliant than those who do not. The Oversight Board recommends improved information reporting and enforcement tools to address large areas of the tax gap related to what has been called a cash economy.

The administration has made several legislative recommendations in this regard. They merit Congressional discussion and consideration, but these recommendations have one thing in common: they require legislative action to implement, and are clear examples of solutions that require coordinated action between the legislative and executive branches.

Third, the Board believes that the IRS must improve customer service, including education and outreach to make taxpayers aware of their legal obligations, and ease taxpayer burdens through modernization. In general, additional IRS resources are needed for both service and enforcement.

Fourth, there should be much greater emphasis and focus on research so the IRS can more effectively target areas of major noncompliance. The board recommends that the IRS develop a long-term strategic plan for research.

Availability of up-to-date research data will allow the IRS to more effectively focus its service and enforcement programs on areas that have the greatest impact on taxpayer compliance and use the change in taxpayer compliance rates as feedback to evaluate the effectiveness of IRS service and enforcement programs.

The Board commends the IRS for adding a voluntary compliance goal for 2009 in its fiscal year 2007 Congressional budget justification, but recognizes that an effective research program must be in place to measure the progress of achieving this goal.

Fifth, the Board urges a more productive partnership between the IRS and the tax administration community. Tax practitioners prepare over 60 percent of the individual tax returns and have a great deal of influence on taxpayer compliance levels.

Although practitioners have professional obligations to represent their clients effectively, they also have an important role in ensuring that taxpayers are complying with their legal obligations. The Senate Finance Committee had a hearing to examine the state of professional tax preparation services available to the public and recently found some troubling results.

Sixth, there must be more emphasis on personal integrity in making decisions. The Board has found that the vast majority of taxpayers state that their personal integrity is a very important factor in influencing their tax compliance. In our 2005 survey, 82 percent of the taxpayers cite personal integrity as the principal factor for reporting and paying their taxes honestly.

In summary, the board recognizes that no single initiative or program will solve the tax gap. A multi-faceted effort must be taken to shrink it. Although we believe more IRS resources are needed, the plan must move from just applying additional resources to it to doing more than is being done today.

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

Thank you, Mr. Chairman.

Senator KYL. Thank you. I want to thank all of the panelists. I think this is enlightening, and slightly encouraging, from my perspective, but obviously raises a variety of questions that we would like to follow up on.

The first point that I would say is somewhat encouraging—and I would just ask if anyone dissents from this point of view—those who expressed a view seem to believe that the majority of the problem is inadvertent, it is not intentional, and that we would do well to try to improve the ease by which taxpayers could comply as a first response to this rather than immediately turning to more enforcement-oriented recommendations.

Would that be a fair overview summary? Yes, Mr. Brostek?

Mr. BROSTEK. In general, yes. But I am concerned about whether we really know whether the errors are intentional or not. There is not very good information on that.

For instance, in the study that we did and reported out this year on capital gains transactions and compliance, a lot of taxpayers who were non-compliant appeared to us to have actually made an intentional decision to be non-compliant because it did not appear to them to be cost-effective.

If they had a small potential tax liability, it may not have been worthwhile for them to pay a practitioner to research the basis of their stock transaction or for them to spend a lot of time researching it. So I think we actually need better information before we can really determine the proportions of intentional and unintentional.

Mr. GEORGE. Mr. Chairman, if I may.

Senator KYL. Mr. George?

Mr. GEORGE. I concur with Mr. Brostek on that. Again, we do not have enough information. While I am a sanguine person generally, and I agree that I would hope that most people would not intentionally cheat on their taxes, we just do not know.

Senator KYL. Maybe I should not have started with such a broad, optimistic point of view, because obviously it is all subject to further calibration.

Ms. Olson?

Ms. OLSON. Well, I share your optimism, sir. I believe that our lack of knowledge applies to it. We do not understand the reasons for non-compliance across the board. The instance that Mr. Brostek described is what I would call procedural non-compliance.

They made an intentional decision to not go and hire someone to track down the actual basis in the stock, but it was because the process was so complex. So if you made safe harbor rules or you enacted basis reporting, you would eliminate that "intentional" non-compliance.

Senator KYL. This goes to another point. With some trepidation, let me try this. Would it also be the case—several of you mentioned it—that among the first things we should consider doing, is simplifying the code to make compliance easier? All right. I should have started with that. That is something that I think has broad-based support.

But probably, Mr. Wagner, you are one of the first to say that the implementation of such a generally agreed upon concept is, nonetheless, a little bit more difficult. It is easier said than done, in other words.

Mr. WAGNER. I think that is right, Mr. Chairman. It is easy to say that we want to simplify the code, and certainly we recognize the complexity of that in and of itself.

The President's Tax Reform Panel of earlier this year had countless suggestions for simplifying the tax code. But settling on a particular portfolio of those, there are winners and losers, and that is what makes it challenging. But that said, there are issues such as information reporting which should be addressed and can, I think, be addressed with some consensus.

Senator KYL. It certainly would be a good place to start.

Let me just ask—and I am not sure which of you are the best. Perhaps Dr. Mazur—do you know what the current audit rate is and how it compares to previous years? What I am getting at here, is this.

Even though enforcement may not be the most efficacious way to reduce the tax gap, is there a way, really, of analyzing the deterrent effect that audits and enforcement have?

Dr. MAZUR. Sure. A couple of things. First, there is no one single audit rate. If you look at different groups of taxpayers you will have different audit rates.

The largest corporations in America get audited at a rate of probably 40 or 50 percent, where individuals, on a whole, get audited at a rate of less than 1 percent. Higher-income individuals get audited at a slightly higher rate, middle-income individuals at a slightly lower rate.

Second, in terms of what the effect of audits are on compliance, there are a couple of academic studies that have looked at this. This is referred to in a couple of the testimonies, these indirect effects.

The idea of indirect effects is, if we audit Mike, Mike goes and tells his friends he was audited, and that makes his friends somewhat more compliant. Basically, the word is out that the cop is on the street.

So the indirect effects, as Nina pointed out in her testimony, can be quite large. They can be 3, 5, 10 times as large as direct effects, depending on the activity that is taking place.

Senator KYL. Any other comments? I have 20 seconds left, and will come back for the next round. But any other comments from the panel?

[No response.]

Senator KYL. In that case, Senator Jeffords?

Senator JEFFORDS. Dr. Mazur, I gather from your testimony that our research on the tax gap is sporadic. I have seen a figure from the 1970s, one from the 1980s, and we have figures from the 1988 and 2001 tax years, from such studies. Given the time lags and differing approaches, do we know if the problem is getting better or worse in these areas?

Dr. MAZUR. What you are referring to is the taxpayer compliance measurement program from the 1960s, 1970s, and 1980s, which was a very comprehensive research program where IRS, every year, did some sort of reporting compliance studies, so there were regular report-outs of different types of compliance for different types of taxpayers and different types of activities. There was a hiatus in the late 1980s through probably 2001 or so, where the IRS did very little of this.

So beginning in tax year 2001, we have a National Research Program plan that looked at individual income taxpayers and tried to determine their behavioral compliance.

We cannot tell whether the 2001 numbers are better than 1999's, or worse, because we do not have all those data points to fill in. That is part of the reason that it is important to do these types of studies on a regular basis, because it allows you then to have a data trail and you can tell whether you are making progress or not.

Right now, we have a couple of data points. We cannot tell whether, in the intervening years, things got better and worse, or things got worse and got better. We just have two data points.

Senator JEFFORDS. Let me continue with you. Since the National Research Program relies on a sampling of tax returns, could you describe how you estimate the tax gap for non-filers and what the limitations are in doing so?

Dr. MAZUR. Sure. For non-filers, at the simplest level, you can think of using two different data sets to determine what the non-filing rate is. We can look at Census data, say from the Current Population Survey, and determine how many individuals look like they have a filing obligation. We can compare that with the number of returns that show up at the IRS. We say the difference is the number of folks who had a filing obligation who did not file.

We have also worked with staff at Census to develop estimates of the size of that dollar tax gap, where Census uses their data and tax data, which they are legally entitled to look at for purposes of developing the Census, and comes up with an estimate of the non-filing gap for individual taxpayers.

It is much harder to do that for other types of taxpayers. For instance, on the corporate side we do not have a good sense of how many corporations have a filing liability because there is no national database we can go to and say, here are all the corporations in America that should be filing taxes.

Senator JEFFORDS. For Mr. Brostek, and anyone else who wants to volunteer. One approach we can take is adding resources for enforcement. It seems there is a good bit of low-hanging fruit; for example, millions of a balance due account being shelved at a cost of tens of billions of dollars. Are we being penny wise and pound foolish here?

Mr. BROSTEK. Well, I suppose that depends on what the alternative uses are of the money. There are obviously national needs across the entire Federal budget, and it is for you and your fellow members to make decisions about the relative priorities. I think it is true that an additional investment in IRS enforcement activities would yield additional funds.

Senator JEFFORDS. You used several ratios. What is the bottom line?

Mr. BROSTEK. What is the bottom line in terms of how much money can be raised?

Senator JEFFORDS. Yes.

Mr. BROSTEK. Unfortunately, I cannot give you a clear answer on that. It would depend not only on how much money IRS was given, but how it decided to allocate those funds, because there are considerably different returns on investment. Across the enforcement tools that IRS uses they try to make judgments about what the

best mix is in allocating their resources, but some tools do pay a higher return than others.

Senator JEFFORDS. Mr. George, I will turn to you.

Mr. GEORGE. Actually, Senator, can I address the question, just very briefly?

Senator JEFFORDS. Yes.

Mr. GEORGE. We need to keep in mind that another word for enforcement is audits. And while an audit can take as little as one hour, it can also take several years. So it really depends upon what burden you are willing to put on the taxpayer in order to accomplish that goal.

Senator JEFFORDS. Mr. George, I was interested in your comments on the limits of NRP, for example, with regard to non-individual taxes owed. I am especially interested in the 2004 figures of the researchers in the Small Business and Self-Employed Division, which suggested a possible $1 trillion in taxable income for a portion of non-filers. Could you expand a little on that?

Mr. GEORGE. If I may, actually, Mr. Chairman, we have the subject matter expert from TIGTA who has the expertise on this area, and if I could ask him to address that question. His name is Philip Shropshire.

Senator JEFFORDS. Well, I will ask him.

Mr. GEORGE. Thank you.

Senator JEFFORDS. Please come up.

Mr. SHROPSHIRE. That was a study that was done by the Internal Revenue Service Small Business Division, and what they did is they went out and they took information documents and matched them to the small business filers. What they came up with was a tremendous amount of income that had not been reported.

Now, this is all potential. They really did not go any further than that. It was just a research project. But what is interesting about this is that nothing further has come out of using information documents to look at business taxpayers and how compliant they are.

Senator JEFFORDS. Thank you, Mr. Chairman.

Senator KYL. Thank you, Senator Jeffords.

Ms. Olson, I think you paraphrased the old, you go where the ducks are. The cash economy is where the dollars are, I think, is the way you put it.

One of the concerns about our economy these days, on a cash basis, is, of course, the extent to which illegal immigrants are paid in cash. Since one of the potential resolutions of the illegal immigration problem relates to paying back taxes, one wonders how that might be resolved.

Could any of you speak to the question of whether there are any estimates as to the amount that illegal immigration contributes to the problem of the tax gap, and any other observations relating to the cash basis and potential for collections there?

Ms. OLSON. Well, probably Dr. Mazur can speak more about the tax. I think that the undocumented workers in the illegal immigrant population, there is a positive effect and a negative effect. They have withholding and Social Security taxes taken out, and then there is a large cash economy in that population, too.

Some of my proposals to address the overall cash economy will impact the cash economy in the undocumented worker population. There is a large population in the construction industry.

I have proposed a method that the United Kingdom has used for 30 years, which is to require backup withholding on the construction industry workers unless they can produce a compliance certificate from the tax authority to their employer saying they are in compliance; they have entered into installment agreements to get rid of back debts and/or they are making estimated tax payments, and then the employer does not have to be burdened with withholding on an independent contractor.

I also have recommended that the IRS use existing local data, for example business licenses, where businesses have to report their gross receipts to local authorities, and that we match that to our Federal returns to see if these people even show up on our rolls. There are lots of ways to track this, because people really do touch governments at different levels—local, State, Federal.

Senator KYL. One of the keys to resolving the problem of illegal immigration in a comprehensive way is to ensure that employers hire only people authorized to work. If that is done properly, then the proper kind of withholding and payment for Social Security and so on will be achieved, and presumably the proper tax compliance.

But it does assume that the employer is complying with the requirements of reporting in the first instance. I am wondering if there is any estimate at all from any of you as to the magnitude of the non-compliance on the employer part of this.

We are talking about folks who pay in cash, and the employee takes it in cash, and really the government has no reason to ever know that the employment has occurred or that the payment has been made.

Yes, Dr. Mazur?

Dr. MAZUR. I have seen a couple of studies, one cited by the Pew Hispanic Trust, where there are about 7 million unauthorized immigrants in the workforce, and probably about three-quarters of them pay payroll taxes. So in a sense, those are in the reported economy. Now, whether they pay payroll taxes under a valid Social Security number and so on, that is a different issue.

Senator KYL. Presumably, they would pay a full amount of the payroll taxes if they are on that system, so presumably about a fourth then do not under that particular study.

Dr. MAZUR. It would be under sort of a cash——

Senator KYL. All right. Does anybody else have any data on that, or anything else? [No response.] We will undoubtedly want to come back to that. The whole matter of cash basis is a matter of concern.

Ms. Olson, let me ask you something else. You talked about inadvertence. Have you netted this out? I mean, obviously inadvertence works both ways. It can be to the advantage of government as well. So has this been netted out to reveal a result that is just to the government's detriment?

Ms. OLSON. I am not aware of that. Now, I know that the GAO study looked at that in terms of capital gains basis reporting and found 33 percent of the errors in the capital gains area was harmful to the taxpayer, they over-reported their income from capital gains. Can you apply that to the rest? I do not know.

Senator KYL. Any other observations on that particular point? Yes?

Dr. MAZUR. One thing that is very hard to tease out of the data, though, is what the motivation of the taxpayer was. I think one of the reasons, in the data that Nina cites, where there are a very small number that are attributable to intentional errors, is that the standard for saying it is an intentional error is fairly high. In a sense, you are accusing the taxpayer of doing something that is borderline fraudulent.

Senator KYL. So the category of inadvertence may be a tad large, for definitional reasons. Understood.

Mr. BROSTEK. Just as a small addition on that, there can be a lot of variation in the judgment of people about whether something is intentional or not.

Senator KYL. Sure.

Mr. BROSTEK. In the late 1980s, there was a study done on EIC compliance. IRS had some of its Criminal Investigative Force make an estimate of the level of compliance, and they asked those criminal investigators to make a judgment about whether the non-compliance was intentional or not.

My recollection is, there the judgment was pretty high, maybe something on the order of 50 percent. But there can be a lot of variation in the judgment, which is subjective judgment on the part of somebody, about the taxpayer's motivations.

Ms. OLSON. There is a group of social scientists that has tried to do a typology, like categories of non-compliance, rather than just going to unintentional. They really go to the understanding of the taxpayer, the behavior of the taxpayer. I think that is just much more effective.

If we were to do this again, I would suggest that the IRS needs to give better instructions to its auditors, narrow down the categories, and then you would really get some more meaningful data, both in terms of how taxpayers behave and how to address that behavior.

Senator KYL. If any of the others have observations, fine. Otherwise, I am going to turn to Senator Jeffords for his round.

Senator JEFFORDS. I have no further questions.

Senator KYL. Well, in that case, let me continue then. Oh, I am sorry. Senator Lincoln has arrived. How embarrassed I am that I did not acknowledge your presence, Senator Lincoln, who have been very, very interested in this subject, I am well aware. The floor is yours.

Senator LINCOLN. Thank you, Mr. Chairman. I want to thank Chairman Kyl and Senator Jeffords, because I am so glad we are here today to really take a much closer and serious look at this very serious issue of the tax gap.

It is an issue that I know our Ranking Member Senator Baucus and Chairman Grassley also continue to put forth a phenomenal effort on here in the overall Finance Committee, so I am pleased that Chairman Kyl and Senator Jeffords have brought it up in our subcommittee.

I am certainly pleased that we are continuing the discussion. I know that the testimony that is being provided today will be very useful as we continue our work. You all bring a whole variety and

a wide range of perspectives in terms of what the issue is, as well as what the solutions might be.

I continue to be astounded at the amount of taxes that are owed and not paid. We are not talking about a small amount of revenue loss here, we are talking about hundreds of billions of dollars which are much needed in terms of other areas of investments that we would like to make in this country.

So any progress we can make in closing that gap, I think, is going to be significant, and it will make it so much easier for us to continue making progress on our policy objectives, whatever they may be, whether it is simplification or other initiatives.

This issue must be a priority, I think, for the Senate, and it must be a priority for the administration. I think it is evident through the testimony that we heard today, and that we continue to hear through written pieces, that we have to take a multi-faceted approach to the problem, an approach that considers both our legislative options as well as administrative options.

As a result, we here in the Finance Committee, no matter how hard we try, cannot solve the problem on our own. Not only do we need the valuable input that you provide, we need cooperation—real cooperation—from the Treasury and the IRS. That is going to be essential.

So I just want to urge the administration's officials to come to the table on this. For us to do our job here, we need to know what the IRS is thinking and what they are doing, what their intentions are, and how we can be helpful in moving that forward.

I think we owe it all to the honest taxpayers in this country who are unfairly bearing the financial burden of those who do not pay what they owe; whether it is known or unknown to them, nonetheless, what is really owed to the country in terms of the objectives we want to reach.

Mr. Chairman, I just have a couple of questions.

Ms. Olson, I think your point on the voluntary compliance is so accurate. You were just mentioning in the previous question about education. We are never going to see significant progress on this issue if we do not first recognize that voluntary compliance is a huge key.

Even if we were to double, triple, or quadruple the IRS enforcement resources, it is never going to be enough to police everyone. We know that. I do not know, Mr. Chairman. Maybe it is a Southern thing. But I keep thinking that we catch more bees with honey.

I guess my question is, to any of you all, how significant is taxpayer service on the front end, through outreach and education, better knowledge of the system, and the processes?

How important is that right now, and how big of a role could it play? What kind of a helpful tool could it be in closing the gap where more focus is placed on it? It seems to me that many taxpayers would probably pay what they owe if they could only figure it out.

I can only be reminded of my husband's comment, who looks at the wall with 8 or 10 diplomas on it, and says, "I cannot believe I cannot do my own taxes. With all of this education my parents paid for, and here taxes are so complicated, I cannot seem to do it."

What kind of a role do we see that playing?

Ms. OLSON. Ten years ago, the IRS did a study that showed that, for every dollar that the IRS spent doing return preparation, it generated $396 of additional tax revenue. When you look at the indirect effect of something, I mean, that is a direct effect. That is very large.

So, you would think that the IRS would be putting more emphasis on doing the income tax preparation, particularly since its returns are the most accurate of any type of preparer, by its own measures and studies.

But since 2003, it has literally cut in half the number of returns that it, itself, is preparing at its walk-in sites. I think that is penny wise and pound foolish.

Senator LINCOLN. Yes.

Mr. GEORGE. Senator Lincoln, if I may.

Senator LINCOLN. Yes.

Mr. GEORGE. There is no question that simplifying the tax code would certainly help address the problem you articulated. However, it is not easy to simplify the tax code.

Senator LINCOLN. We know that around here. [Laughter.]

Mr. BROSTEK. Senator Lincoln, if I could jump in here. Even without simplification, it is certainly true that service to taxpayers is very important for them to be able to comply.

One of the things that I thought was illustrative was some work we did 2 or 3 years ago, where we looked at whether IRS actually takes the forms and instructions that they expect taxpayers to follow and sits down with taxpayers and asks them to go through the forms, go through the instructions, to see if they make sense to the taxpayer.

I forget the exact number, but there were hundreds of changes that had been made to the tax forms in the period we looked at, and there were less than a handful of times when they had actually tested the form with the taxpayer. We made recommendations that they improve that effort so that up front we can reduce the confusion of the taxpayer and increase their voluntary compliance.

Senator LINCOLN. Exactly.

Mr. WAGNER. Senator, I might add that the Oversight Board has been focused on driving the message that taxpayer service up front is critically important, and really is the answer. That, of course, needs to be balanced with the proper amount of enforcement, because enforcement, too, drives voluntary compliance. So, there is a balance there.

But up front, customer service, whether it is answering the phones, whether it is providing walk-in service, whether it is clear instructions, more clarified forms, they are all critically important.

Senator LINCOLN. Thank you.

Mr. Chairman, you are going to have a second round, correct?

Senator KYL. Yes.

Senator LINCOLN. I will save my next question.

Senator KYL. All right. Thank you.

Right on that same point, and I do not know all of the ins and outs about how this is actually administered, but I noted, Mr. Brostek, your testimony about the EIC. Six years ago, there was

a $10 billion loss there. A lot of that is governmental administration.

So, just following up on the last point that we made, how could we improve, just in that one area, the collection, given the fact that there is government involvement, at least?

Mr. BROSTEK. Well, a few things come to mind there. As you probably know, the IRS has been experimenting with some alternative techniques to try to improve the compliance level, asking some taxpayers, some of the EIC taxpayers, to present various documents ahead of the filing season that IRS can take a look at and try to make a judgment whether the taxpayer complies or not.

They have done this type of research, and I think part of what would be useful is congressional oversight to see whether the results of those initiatives could, or should, be expanded from a relatively small number of taxpayers who are involved to a larger part of the universe. I do not know for sure that that would be effective.

One of the things that must, I think, be kept in mind here, is that a program like the Earned Income Credit has really a very small administrative cost compared to most social services programs that are directly administered by government employees.

You sort of have a trade-off, in part. You get low administrative cost and a lot of self-certification on the part of the taxpayer that they qualify for this benefit, if you will.

But if you have a higher administrative cost, you have a government employee actually checking whether those qualifications are met, and you have a lower non-compliance rate. It is a judgment about whether we would like to turn this program more into a high administrative cost program, but we would have an ultimately lower non-compliance rate.

Senator KYL. Yes. Dr. Mazur?

Dr. MAZUR. A couple of things. One, as Mike Brostek points out, having the administrative costs low does a couple of things. It drives down the cost of running the program, but it also increases the participation rate.

So the Earned Income Credit has one of the highest participation rates of any social service program, which really means we have gotten more folks in, and really it leads it to becoming a very effective anti-poverty program.

Senator KYL. The concern I have here in representing taxpayers is this is the kind of thing that drives them nuts, because there is a government involvement there that seems to be allowing misreporting, perhaps even fraud. I was going to ask about the prison system. I have forgotten which one of you mentioned the fraud.

Mr. GEORGE. I did, Mr. Chairman.

Senator KYL. Yes. The fraud and prisoners, a 318-percent increase. Talk about things that drive people nuts. That is high profile. In one sense, it is an opportunity because it gives us something that we can get people's attention on to begin to focus on, which then ripples out into a lot of other areas that we can potentially improve, too. But how about a program like that?

Mr. GEORGE. And I would just point out, sir, that the Earned Income Credit is one of the credits that the prisoners are taking advantage of. The irony is, for those who have been incarcerated for

more than 6 months, they would not qualify under the standards laid out by the IRS for the credit.

Ms. OLSON. I think that there is one thing that you can do about the prisoners. I believe the House has proposed some legislation on that. I am usually a confidentiality-of-taxpayer-information hawk, but in this instance I think it would be important for the IRS to be able to share with the prison wardens that they have received fraudulent returns from prisoners.

If we just stop a refund, what does that do to the prisoner? There is no punishment. They are already in jail. So to me, take away their cigarettes, their television privileges. We cannot do that, the warden needs to do that.

Senator KYL. And it is a very light intrusion. There is another question I want to get in about the relative benefit of intrusiveness.

Ms. OLSON. Right.

Senator KYL. All that is, is just sending in a name, saying, I have got a refund here.

Ms. OLSON. Exactly.

Senator KYL. Very good.

Let me ask one more question here about the private debt collection efforts. I know that we are just beginning to potentially see some collections there. I am not sure, Mr. George or Mr. Brostek, who would be the best one to comment on that. But what do we anticipate in the private debt collection area?

Mr. GEORGE. If I may start, Mr. Chairman. As you may recall, 10 years ago a pilot was attempted by the IRS, which failed and failed miserably. It cost more than was ultimately collected. The American Jobs Creation Act renewed this effort. We are optimistic that, if effectively run, it can achieve the goals that Congress intends.

However, as with every other major government effort, it requires massive oversight. TIGTA is currently engaged in an effort to educate those whom the IRS has selected to participate in this program to, at the outset, inform them of what they should and should not do.

This has the potential to be a great benefit to government in terms of reaching out to taxpayers who owe debt, and it also has the potential, sir, of being a nightmare if abused. So, we are very concerned about this. We are going to be very aggressive. I have communicated directly with the Commissioner about this concern.

Mr. BROSTEK. We, too, have concerns. We are doing some ongoing work right now for this committee, the Chairman and Ranking Member. We do not have the results of that available yet.

Your specific question, I believe, was on the potential benefit. I believe the estimate of additional revenue that could be gained when the program began was on the order of $1 billion, maybe $1.2 billion, over a 10-year period of time. But as Mr. George says, it is a program that will bear watching closely because of the potential down sides.

Ms. OLSON. If I might, sir. I, too, am very concerned. We have been very involved in this initiative, prior to even the legislative language being enacted.

I am concerned that the benefits are going to be overstated because we are not adequately measuring the actual costs. We are

only going to be looking at what we pay out to the private debt collectors and not looking at the work that the IRS has to do in order to pick up some of the cases that the private debt collectors cannot handle.

My office is going to be tracking that aspect of it. I am concerned that many of these taxpayers will come in and say, well, I will pay the tax, but I want the penalty abated.

Constitutionally, private debt collectors cannot make that decision, so then the case needs to go back to the IRS. Maybe we should have worked this case from the start. Now we are doing duplication of resources. We are paying the private debt collectors, but we are also paying the IRS employees.

Mr. WAGNER. Senator, I might add that the Oversight Board has expressed an opinion in support of the private debt collectors, with the understanding that these organizations—TIGTA, GAO, Taxpayer Advocate—will be closely watching and overseeing the activities, and the Board itself will be involved in that.

We have observed that private debt collectors have worked at the State level and have been successful at the State level. There are costs, certainly, and there is talk of collecting $10 billion over 10 years, but there are indirect benefits as well.

With more boots on the ground, so to speak, engaged in enforcement activities, that does have an indirect benefit, which perhaps is not being measured and cannot quickly be measured without the additional research that we have talked about. So, we are certainly open-minded and see it as a tool, as one arrow in the quiver, for enforcement and closing the tax gap.

Senator KYL. Great. Thanks.

Senator Jeffords, you do not have any more questions?

Senator JEFFORDS. No.

Senator KYL. I will turn to Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman.

Dr. Mazur, as a long-time advocate for small businesses, I have been very interested in your ongoing compliance study that focuses on the S corporations.

While I am sure we share the same goal, that all taxpayers should definitely pay taxes that are owed, I also want to ensure that we do not end up placing an undue or unreasonable burden on taxpayers, especially our small businesses. In my State, small businesses are our largest employer. Actually, in most States they are the largest employers.

What is the progress on your study that you might be able to share with us? Do you have an anticipation of when you might have your completed results?

Dr. MAZUR. Sure. The study is ongoing. We have roughly 5,000 S corporations in the study. It covers 2 tax years, tax year 2003 and tax year 2004. In very rough terms, about 1,200 returns are for tax year 2003. Those audits are, for the most part, all started. A few hundred are done.

The tax year 2004 ones, the audits, there are 3,800. The audits have gone out to the folks in the field. They have begun setting up appointments with taxpayers.

We are expecting about a 2-year cycle for these audits. They take some period of time to complete, and the stragglers need to get

brought in. So basically, we are expecting the results to be done sometime in 2007/2008, and then some period of time after that, while we massage the data and get to understand it a little bit better, have results for you.

Senator LINCOLN. Great. Thank you.

We have all talked about simplification and expressed, certainly, how important it is. It has to be a part of our discussion. Our tax code, in its current form, seems to be overly burdensome and far too complex, I think, for your average taxpayer. I think it is no wonder that they are not necessarily complying all the time.

Ms. Olson, or any others who might want to comment, would you mind outlining for me a few of the changes, maybe, in the code that you think would be helpful, particularly for taxpayers, as we move toward that simplification?

Ms. OLSON. Well, over the years, in our annual report, we have identified some. I would have to say the big one is going to have to be the Alternative Minimum Tax. If we look forward to 2012, we have 33 million taxpayers who are going to be impacted.

I think Treasury had projected that 92 or 94 percent of married couples with two children, by 2010, with income between $75,000 and $100,000, will be impacted by the AMT, that for them the AMT will be the tax rate. That is just something that is intolerable. You talk about inadvertent non-compliance or calculated non-compliance. They just are not going to be able to figure it out.

We talked about some changes and improvements to the Earned Income Credit. We have looked at the retirement provisions and the education credits and incentives in the code.

We have so many retirement provisions, that people get confused, and they get confused about when they can take out early withdrawals, and then they get taxed on that because under one plan it is not subject to a 10-percent penalty tax, but under another type of plan, that particular reason for a withdrawal is subject to the additional tax.

Senator LINCOLN. Mr. George?

Mr. GEORGE. Senator Lincoln, I would associate my comments with those of Ms. Olson. I would point out, I guess the touchstone really should be, is the provision doing what it was intended to do when first passed by Congress, whenever it was? Again, the first provision I was going to point out was also the AMT.

Senator LINCOLN. Well, we always appreciate that, knowing that our original intent is preserved. So, hopefully there will be some of that.

Mr. BROSTEK. I agree that these are all good targets of opportunity. One piece I would add. We did some work on the education provisions. We looked at the tax provisions, as well as the grants and loans that are available, in one report to gather information across all those provisions.

But we did some testing on a small number of the tax provisions to see if we could tell whether taxpayers were making the best choice for them. We found hundreds of thousands of individuals who were not making the best choice for themselves.

This has nothing to do with whether they were non-compliant, just whether they were getting the best support for post-secondary education expenses that they had. I think that is a telling piece of

information about how confusing this plethora of different techniques can be in the tax code.

Senator LINCOLN. So, financial literacy and the ability to marry that financial literacy with the tax code is going to be a critical component of making sure we are successful, it sounds like. So, thank you.

Thank you, Mr. Chairman.

Senator KYL. Thank you. I would like to just ask one last question, really to all of you, but probably starting with Mr. Wagner, since you are responsible for weighing, in your business, the advantages of—let me put the question another way.

Reporting by third parties can create great advantages for tax collection, but create problems in costs for the businesses or third parties who are doing the reporting, so weighing the relative benefits or burdens there, I think, is something we have to do. In business, one has to do that.

So do you have any suggestions, as we draw this to a close, as a general proposition that we should be looking at in the data that we are going to be collecting that would help us to approach this question of weighing the relative benefits and burdens of third party reporting? We know, in the abstract, it will certainly help us, but we also appreciate that it will create costs for people who really do not deserve to have those costs imposed.

Mr. WAGNER. Well, I think, Senator, you have captured the essence of it. That is, weighing and balancing the burden. The theme of research would certainly come into play at this point in time.

But I think not all reporting is going to be as burdensome as it may seem on the face of it. For example, you look no further than a few years ago when Social Security numbers were a newfound requirement, and suddenly 7 million dependents fell off the tax rolls. That was a matter of reporting.

So there are burdensome forms of reporting, but yet, much of the information in today's modern society, in today's simple banking records, statements that are received from vendors, computerized records, could be required to be provided or kept in the ordinary course of business, much as the new accounting requirements are imposed upon companies, and much of this is already gathered.

So I think there could be considerable study that would achieve the right level of intrusion and balance. Certainly, no business wants to have any additional burdens of cost for reporting, or any other regulatory method. But there is a proper role for that.

Senator KYL. Maybe we could give them a break. We could reduce their tax rates so they will report more data to us.

Mr. WAGNER. Well, that warrants consideration.

Senator KYL. Thank you.

Mr. Brostek?

Mr. BROSTEK. Just one thing on that. I would just make one little, slightly unrelated, plug. On the burden, I think it is important to keep in mind that we should take into account the burden of the taxpayers, as well as the third parties.

I think in many cases, if you add both of those burdens up, after you go to information reporting, the net burden goes down. For instance, the cost basis. You have millions and millions of taxpayers

who have to individually figure out, what are these rules? Then they have to go research to find what the history of their stock is.

If you have a central choke point, a brokerage firm that knows those rules for all of their clients and that has record-keeping systems that are fairly sophisticated, I think you might get a net reduction in overall burden, counting both parties, by going to third party reporting.

The unrelated plug I would like to put in is, going back to one of the things that was mentioned earlier, the importance of the practitioner community. One of the things that I found eye-opening recently, work we did for this committee, was we went out and had tax returns prepared this year in 19 instances, a small, small sample.

In every single case, the practitioners made mistakes. In half of those instances, they were very significant mistakes from the taxpayer's perspective, losing them $500, $2,000 apiece, sometimes gaining them that money.

Sixty percent of taxpayers—maybe a little more than 60 percent of taxpayers—use paid preparers these days. This is a community that is an important choke point for compliance in our system. The small study we did suggests that that deserves some attention. Thank you.

Senator KYL. Good point. We appreciate it.

Dr. Mazur?

Dr. MAZUR. I just want to follow up on the point about the burden of both parties in here. Just think about if you had to figure out what your interest income was every year rather than getting a statement from your bank telling you what it was. You would have to be saving the statements, you would have to be looking, trying to figure out what it is.

Now you get a statement in January that says, here is the total, just put it on the line. So, really, in that case, while there is some burden on the bank to send you that statement, the combined burden has got to be less.

Ms. OLSON. To that point, burden may be something that was a problem years ago, but today, because of technology, it is not. Again, in the capital gains cost basis area, today there is a private clearinghouse that is run by broker dealers, the New York Stock Exchange, and NASDAQ. It is a cost basis reporting service. They offer that.

We were advised that brokers that handle 80 percent of all account transfers are using this service today. Now, 10 years ago, they were not using that, so the burden is not that great on these folks to do that, to get that extra 20 percent.

What we had proposed was maybe give a one-time tax credit for transition costs, because the cost of that going out the door is overcome many times by the revenue that you are going to get in by just implementing this provision.

Mr. GEORGE. Mr. Chairman, I would just point out, again, that under-reporting of income is the largest component of the tax gap. So I would advocate, and I know TIGTA takes the position, that third party reporting would certainly be an effective tool to address that problem.

Senator KYL. I really appreciate all of this information. I went less into some of the intricacies of the data collection and evaluation, which was one of the purposes for the hearing, but as you can see, we tend to jump right to, what kind of solutions might we want to consider?

I am sure I speak for all of the members of the committee on both sides in expressing my gratitude to you, and my hope is that, as we proceed, that we will be able to call upon you for continuing advice; I know several of you have been working with the committee in the past. It is an important issue.

For those of you who are working for the U.S. Government, I hope our constituents can be proud of the kind of work that you do. And those who are doing volunteer service, we are proud of that, too. So, thank you very, very much.

Senator Jeffords, any closing comments?

Senator JEFFORDS. Just to follow up on what you have just said, I think we need to make sure that the tax code gets simpler and that people are more knowledgeable and they have a better ability to understand what is going on.

Senator KYL. Thank you very much.

The hearing is adjourned.

[Whereupon, at 3:25 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Statement of Senator Max Baucus
"A Closer Look at the Size and Sources of the Tax Gap"
Hearing before the Subcommittee on Taxation and IRS Oversight
Committee on Finance
July 26, 2006

Who can afford to lose more than $10,000 a second? No one can. But with each passing second, the Federal Government fails to collect another $10,000 that it is legally owed. With each passing second, the tax gap grows by $10,940.

Using 2001 data, the IRS estimates the annual tax gap to be $345 billion. The tax gap is the difference between the taxes legally owed and the taxes timely paid. At this rate, the cumulative tax gap has grown by $2 trillion since 2001.

It is time to reverse the growth of the tax gap. By collecting the taxes that already are legally owed, the Government could reduce the budget deficit and our nation's dependence on foreign borrowing, without raising taxes on anyone.

Closing the tax gap makes good business sense. And it makes good common sense. Whenever one person who owes taxes fails to pay, honest taxpayers have to make up the difference. Americans already face increasing health care costs, tuition, and gas prices. We should do what we can to minimize the tax burden on those who voluntarily pay what they owe.

The tax gap has been on my radar screen for years. I have proposed legislation to shut down abusive tax shelters, beef up enforcement against offshore financial accounts that conceal taxable income, and establish quality standards on paid tax preparers.

In 2004, when the IRS reported a voluntary compliance rate of 85 percent, I challenged the IRS to increase that rate to 90 percent by 2010. Instead, the latest IRS figures report a voluntary compliance rate of 83.7 percent. The tax gap is headed in the wrong direction.

Many factors contribute to the tax gap. Some don't file any tax return at all. Others report only part of their income. Others overstate their expenses. Many don't pay what they owe.

The causes of the tax gap are multi-faceted. The solution needs to be, as well.

Developing a tax gap plan would be a good start. The American public has a reasonable expectation that our nation's tax laws are being administered fairly, efficiently, and effectively.

Former IRS Commissioner and Chief Counsel Sheldon Cohen observed: "Law is not what the Congress passes, law is what you are willing to enforce. Law without enforcement might just as well never be enacted."

Farmers in Montana know the importance of a plan. They don't walk out into the middle of a field, scatter some seed, close their eyes, and hope for the best. Instead, they prepare the soil, plant the seed, fend off pests and weeds, and watch the crops carefully so that they know just the right time for harvest. They have a plan.

Like Montana's farmers, the IRS needs a credible and comprehensive plan to close the tax gap. The plan should include baselines, goals, benchmarks, and measures. Several GAO and Treasury Inspector General for Tax Administration reports have chided the IRS for its inability to measure results and track progress.

At his confirmation hearing in March of 2003, I asked nominee Mark Everson, now the IRS Commissioner, what concrete steps he planned to take to close the tax gap. I asked him to report to the Finance Committee on benchmarks, including audit rates, modernization, and enforcement data. I have yet to see those reports.

In February of 2006, I asked Secretary Snow at the IRS budget hearing for a plan within 30 days. When he resigned in June, I still had not seen that plan.

At the Committee's corporate tax gap hearing in June, I asked Commissioner Everson for a credible plan by September 30 to close the tax gap. Commissioner Everson agreed to provide one.

During Henry Paulson's June 27, 2006, confirmation hearing to be Secretary of the Treasury, I asked him for a credible tax gap plan by September 30. He would not commit to submit one.

On July 13, I made the same request of Eric Solomon during his confirmation hearing to become Assistant Secretary of the Treasury for Tax Policy, but he was unable to make that commitment.

After careful consideration, I decided to place a hold on the Solomon nomination until I receive a commitment from Treasury that it will work with the IRS to provide a credible tax gap plan by September 30, 2006.

It is time to stop talking about how serious the tax gap is. It is time to do something about it. It is time for the administration to produce a credible and comprehensive plan for combating the tax gap.

The administration must respond regularly to tough challenges. Because many of them are unexpected and unpredictable, it can be difficult to plan for them.

The tax gap is different. It didn't pop up overnight. The administration has the opportunity to develop a thoughtful and responsible plan. The administration has an obligation to develop such a plan.

Today, this subcommittee will hear testimony from Ray Wagner, the Chairman of the IRS Oversight Board. Earlier this year, the Board proposed a six-pronged approach to closing the tax gap. The IRS Oversight Board is part of the Treasury family.

The Board recommended tax code simplification, better information reporting, enhanced customer service and improved technology, greater focus on research, partnering between the IRS and tax professionals, and more emphasis on personal integrity. These ideas have merit and should be considered seriously.

Others, including the Joint Committee on Taxation, the National Taxpayer Advocate, the Government Accountability Office, and the Treasury Inspector General for Tax Administration, as well as the professional tax community, have recommended equally credible ideas we must not overlook that could serve as the foundation for a comprehensive plan.

During the time of this hearing, the tax gap will grow by another $60 million. We can't stop the clock. We must stop the tax gap. A tax gap plan would be a good place to start. We simply cannot afford to keep losing $10,000 a second.

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate

For Release on Delivery
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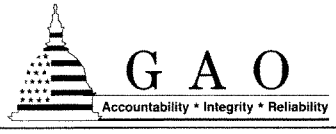
TAX COMPLIANCE

Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches

Statement of Michael Brostek
Director, Tax Issues
Strategic Issues Team



GAO-06-1000T

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Highlights

Highlights of GAO-06-1000T, a testimony to the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate

July 26, 2006

TAX COMPLIANCE

Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches

Why GAO Did This Study

The tax gap—the difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law—has been a long-standing problem in spite of many efforts to reduce it. Most recently, the Internal Revenue Service (IRS) estimated a gross tax gap for tax year 2001 of $345 billion and estimated it would recover $55 billion of this gap, resulting in a net tax gap of $290 billion. When some taxpayers fail to comply, the burden of funding the nation's commitments falls more heavily on compliant taxpayers. Reducing the tax gap would help improve the nation's fiscal stability. For example, each 1 percent reduction in the net tax gap would likely yield $3 billion annually.

GAO was asked to discuss the tax gap and various approaches to reduce it. This testimony discusses to what extent the tax gap could be reduced through three approaches—simplifying or reforming the tax system, providing IRS with additional enforcement tools, and devoting additional resources to enforcement—as well as various factors that could guide decision-making when devising a strategy to reduce the tax gap. This statement is based on prior GAO work.

What GAO Recommends

GAO is not making any new recommendations but highlights new areas for possible attention.

www.gao.gov/cgi-bin/getrpt?GAO-06-1000T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Simplifying the tax code or fundamental tax reform has the potential to reduce the tax gap by billions of dollars. IRS has estimated that errors in claiming tax credits and deductions for tax year 2001 contributed $32 billion to the tax gap. Thus, considerable potential exists. However, these provisions serve purposes Congress has judged to be important and eliminating or consolidating them could be complicated. Fundamental tax reform would be most likely to result in a smaller tax gap if the new system has few, if any, exceptions (e.g., few tax preferences) and taxable transactions are transparent to tax administrators. These characteristics are difficult to achieve, and any tax system could be subject to noncompliance.

Withholding and information reporting are particularly powerful tools to reduce the tax gap. They could help reduce the tax gap by billions of dollars, especially if they can make currently underreported income transparent to IRS. These tools have been shown to lead to high, sustained levels of taxpayer compliance. Using these tools can also help IRS better allocate its resources to the extent they help IRS identify and prioritize its contacts with noncompliant taxpayers. As GAO previously suggested, reporting the cost, or basis, of securities sales is one option to improve taxpayers' compliance. However, designing additional withholding and information reporting requirements may be challenging given that many types of income are already subject to reporting, there are many forms of underreporting, and withholding and reporting requirements impose costs on third parties.

Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of enforcement resources for IRS requires taking into account many factors such as how well IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress decides to provide IRS more enforcement resources, the amount the tax gap could be reduced would depend on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Increasing IRS's funding would enable it to contact millions of potentially noncompliant taxpayers it identifies but does not have resources to contact.

Finally, using multiple approaches may be the most effective strategy to reduce the tax gap, as no one approach is likely to fully and cost effectively address noncompliance. Key factors to consider in devising a tax gap reduction strategy include periodically measuring noncompliance and its causes, setting reduction goals, leveraging technology, optimizing IRS's allocation of resources, and evaluating the results of any initiatives.

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to discuss the tax gap—the difference between what taxpayers pay in taxes voluntarily and on time and what they should pay under the law—and what is achievable in reducing the gap. Most recently, the Internal Revenue Service (IRS) estimated that for tax year 2001, taxpayers paid about 84 percent of the taxes that should have been paid on time under the law, resulting in an estimated gross tax gap of $345 billion. IRS estimated that it would eventually recover around $55 billion of the 2001 tax gap through late payments and IRS enforcement actions, leaving a net tax gap of $290 billion.[1] Because of taxpayer noncompliance, the burden of funding the nation's commitments falls more heavily on taxpayers who willingly and accurately pay their taxes. Reducing the tax gap would help improve the nation's fiscal stability. For example, based on IRS's estimate, each 1 percent reduction in the net tax gap would likely yield nearly $3 billion annually. However, the tax gap has been a persistent problem in spite of a myriad of congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. Likewise, factors such as globalization and the ever-increasing complexity of the tax code further challenge IRS's ability to administer the tax code.

My remarks focus on what is achievable in reducing the tax gap through a variety of approaches, specifically by (1) simplifying or reforming the tax system; (2) providing IRS additional enforcement authority and tools, such as information reporting[2] and tax withholding,[3] through changes to the tax laws; and (3) devoting additional resources to enforcement under the existing tax laws. I will also discuss various factors that could guide decision making when devising a strategy to reduce the tax gap. My remarks are based on our previous work on a variety of issues, in

[1]Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

[2]Information reporting involves the filing of information returns with IRS and taxpayers that contain information on certain transactions, such as wage and salary information employers report to employees and IRS through Form W-2.

[3]An example of tax withholding is when employers withhold taxes on the wages that employees earn and remit them to IRS.

particular, recent testimonies and a report on reducing the tax gap.[4] These efforts were conducted in accordance with generally accepted government auditing standards.

Let me begin by highlighting four major points:

- Simplifying the tax code or fundamental tax reform has the potential to reduce the tax gap by many billions of dollars. For example, IRS estimated that errors in claiming tax credits and deductions for tax year 2001 contributed $32 billion to the tax gap. Reducing the number of such credits and deductions therefore has some direct potential to reduce the tax gap. However, these credits and deductions serve purposes Congress has judged to be important, and eliminating them likely would be complicated. Fundamental tax reform, such as shifting to a consumption tax system, would most likely result in a smaller tax gap if the new system has few, if any, exceptions (e.g., few or no tax preferences) and taxable transactions are transparent to tax administrators. These characteristics are difficult to achieve in any system, and any tax system could be subject to noncompliance.

- Providing IRS with more enforcement tools, particularly withholding and information reporting, also has the potential to reduce the tax gap by billions of dollars, especially if those tools help IRS deal with the largest contributor to the tax gap—underreported income. Tax withholding and information reporting have been shown to lead to high, sustained levels of taxpayer compliance because the income taxpayers earn is transparent to them and IRS. Also, using these tools can help IRS better allocate its resources by improving its ability to identify and prioritize noncompliant taxpayers it contacts. For example, we found that having third parties report to taxpayers and IRS the cost, or basis, of stocks and mutual funds that taxpayers sell could help taxpayers improve their voluntary compliance and help IRS allocate its enforcement efforts concerning these transactions. However, designing withholding or information reporting requirements to address underreporting may be challenging given that

[4]GAO, *Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions*, GAO-06-453T (Washington, D.C.: Feb. 15, 2006); *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance*, GAO-06-208T (Washington, D.C.: Oct. 26, 2005); *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005); and *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, GAO-05-527T (Washington, D.C.: Apr. 14, 2005).

many types of income are already subject to such requirements, there are many forms of underreporting, and any requirements could impose costs and burdens on the third parties that withhold or report.

- Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account factors such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement resources, the amount of the tax gap that could be reduced depends in part on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Providing IRS with additional funding would enable it to contact millions of potentially noncompliant taxpayers it identifies but currently cannot contact given resource constraints.

- Each approach to reducing the tax gap—simplifying or reforming the tax code, providing IRS with more enforcement tools, or devoting additional resources to enforcement—has the potential to reduce the tax gap, although using multiple approaches may be the most effective strategy since no one approach is likely to fully and cost effectively address noncompliance. Some key factors to consider in designing a strategy to reduce the tax gap include periodically measuring noncompliance and its causes, setting tax gap reduction goals and measuring progress against the goals, leveraging technology to enhance IRS's efficiency, identifying and considering the costs and benefits of possible approaches, optimizing the allocation of IRS's resources, and evaluating the results of any initiatives to reduce the tax gap.

Background

The tax gap is an estimate of the difference between the taxes—including individual income, corporate income, employment, estate, and excise taxes—that should have been paid voluntarily and on time and what was actually paid for a specific year. The estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return

altogether or on time.[5] IRS's tax gap estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers. As shown in table 1, underreporting of tax liabilities accounted for most of the tax gap estimate for tax year 2001.

Table 1: IRS's Tax Year 2001 Gross Tax Gap Estimates by Type of Noncompliance and Type of Tax

Dollars in billions

	Type of tax					
Type of noncompliance	**Individual income tax**	**Corporate income tax**	**Employment tax**	**Estate tax**	**Excise tax**	**Total**
Underreporting	$197	$30	$54	$4	No estimate	**$285**
Underpayment	23	2	5	2	$1	**$34**
Nonfiling	25	No estimate	No estimate	2	No estimate	**$27**
Total	**$244**	**$32**	**$59**	**$8**	**$1**	**$345**

Source: IRS.

Note: Figures may not sum to totals because of rounding.

IRS has estimated the tax gap on multiple occasions, beginning in 1979, relying on its Taxpayer Compliance Measurement Program (TCMP). IRS did not implement any TCMP studies after 1988 because of concerns about costs and burdens on taxpayers. Recognizing the need for current compliance data, in 2002 IRS implemented a new compliance study called the National Research Program (NRP) to produce such data for tax year 2001 while minimizing taxpayer burden.

IRS has concerns with the certainty of the tax gap estimate for tax year 2001 in part because some areas of the estimate rely on old data, IRS has no estimates for other areas of the tax gap, and it is inherently difficult to measure some types of noncompliance. IRS used data from NRP to estimate individual income tax underreporting and the portion of employment tax underreporting attributed to self-employed individuals. The underpayment segment of the tax gap is not an estimate, but rather represents the tax amounts that taxpayers reported on time but did not pay on time. Other areas of the estimate, such as corporate income tax and employer-withheld employment tax underreporting, rely on decades-old data. Also, IRS has no estimates for corporate income, employment, and

[5]Taxpayers who receive filing extensions, pay their full tax liability by payment due dates, and file returns prior to extension deadlines are considered to have filed on time.

excise tax nonfiling or for excise tax underreporting.[6] In addition, it is inherently difficult for IRS to observe and measure some types of underreporting or nonfiling, such as tracking cash payments that businesses make to their employees, as businesses and employees may not report these payments to IRS in order to avoid paying employment and income taxes, respectively.[7]

IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. IRS seeks to improve voluntary compliance through efforts such as education and outreach programs and by attempting to simplify the tax process, such as by revising forms and publications to make them electronically accessible and more easily understood by diverse taxpayer communities. IRS uses its enforcement authority to ensure that taxpayers are reporting and paying the proper amounts of taxes through efforts such as examining tax returns and matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns it receives from third parties. IRS reports that it collected over $47 billion in 2005 from noncompliant taxpayers it identified through its various enforcement programs.

In spite of IRS's efforts to improve taxpayer compliance, the rate at which taxpayers pay their taxes voluntarily and on time has tended to range from around 81 percent to around 84 percent over the past three decades. Any significant reduction of the tax gap would likely depend on an improvement in the level of taxpayer compliance.[8]

[6]For these types of noncompliance, IRS maintains that the data are either difficult to collect, imprecise, or unavailable.

[7]For a more detailed discussion about data sources and methodologies used in estimating the tax gap, see GAO-05-753.

[8]In some instances, the amount of the tax gap can change without a corresponding change in the level of compliance. For example, a reduction in marginal tax rates could result in a smaller tax gap even if the level of compliance remains unchanged because the amount of taxes that should be paid has been reduced. The tax gap would also tend to increase over time, even if the rate of taxpayer compliance remained unchanged, because of inflation.

Reducing the Tax Gap through Tax Simplification or Tax System Reform Depends on Their Design and May Have Effects Beyond Tax Compliance

Tax law simplification and reform both have the potential to reduce the tax gap by billions of dollars. The extent to which the tax gap would be reduced depends on which parts of the tax system would be simplified and in what manner as well as how any reform of the tax system is designed and implemented. Neither approach, however, will eliminate the gap. Further, changes in the tax laws and system to improve tax compliance could have unintended effects on other tax system objectives, such as those involving economic behavior or equity.

Simplification has the potential to reduce the tax gap for at least 3 broad reasons. First, it could help taxpayers to comply voluntarily with more certainty, reducing inadvertent errors by those who want to comply but are confused because of complexity. Second, it may limit opportunities for tax evasion, reducing intentional noncompliance by taxpayers who can misuse the complex code provisions to hide their noncompliance or to achieve ends through tax shelters. Third, tax code complexity may erode taxpayers' willingness to comply voluntarily if they cannot understand its provisions or they see others taking advantage of complexity to intentionally underreport their taxes.

Simplification could take multiple forms. One form would be to retain existing laws but make them simpler. For example, in our July 2005 report[9] on postsecondary tax preferences, we noted that the definition of a qualifying postsecondary education expense differed somewhat among some tax code provisions, for instance with some including the cost to purchase books and others not. Making definitions consistent across code provisions may reduce taxpayer errors. Although we cannot say the errors were due to these differences in definitions, in a limited study of paid preparer services to taxpayers, we found some preparers claiming unallowable expenses for books.[10] Further, the Joint Committee on Taxation suggested that such dissimilar definitions may increase the likelihood of taxpayer errors and increase taxpayer frustration.[11]

[9]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on the Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

[10]GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (Washington, D.C.: Apr. 4, 2006).

[11]U.S. Congress, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System*, vol. II, 125-6 (April 2001).

Another tax code provision in which complexity may have contributed to the individual tax gap involves the earned income tax credit, for which IRS estimated a tax loss of up to about $10 billion for tax year 1999.[12] Although some of this noncompliance may be intentional, we[13] and the National Taxpayer Advocate[14] have previously reported that confusion over the complex rules governing eligibility for claiming the credit could cause taxpayers to fail to comply inadvertently.

Although retaining but simplifying tax code provisions may help reduce the tax gap, doing so may not be easy, may conflict with other policy decisions, and may have unintended consequences. The simplification of the definition of a qualifying child across various code sections is an example. We suggested in the early 1990s that standardizing the definition of a qualifying child could reduce taxpayer errors and reduce their burden.[15] A change was not made until 2004.[16] However, some have suggested that the change has created some unintended consequences, such as increasing some taxpayers' ability to reduce their taxes in ways Congress may not have intended.

Another form of simplification could be to eliminate or consolidate tax expenditures. Among the many causes of tax code complexity is the growing number of preferential provisions in the code, defined in statute[17] as tax expenditures, such as tax exemptions, exclusions, deductions, credits, and deferrals.[18] The number of these tax expenditures has more than doubled from 1974 through 2005. Tax expenditures can contribute to the tax gap if taxpayers claim them improperly. For example, IRS's recent

[12]IRS measured the extent of noncompliance with the earned income tax credit in a study separate from NRP.

[13]GAO-06-208T.

[14]Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2004 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2004).

[15]See GAO, *Tax Administration: Erroneous Dependent and Filing Status Claims*, GAO/GGD-93-60, (Washington, D.C: Mar.19, 1993).

[16]Pub. L. No. 108-311 (2004).

[17]The Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3, 88 Stat. 299 (July 12, 1974) (codified at 2 U.S.C. § 622(3)).

[18]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

tax gap estimate includes a $32 billion loss in individual income taxes for tax year 2001 because of noncompliance with these provisions. Simplifying these provisions of the tax code would not likely yield $32 billion in revenue because even simplified provisions likely would have some associated noncompliance. However, the estimate suggests that simplification could have important tax gap consequences, particularly if simplification also accounted for any noncompliance that arises because of complexity on the income side of the tax gap for individuals.[19]

However, these credits and deductions serve purposes that Congress has judged to be important to advance federal goals. Eliminating them or consolidating them likely would be complicated, and would likely create winners and losers. Elimination also could conflict with other objectives such as encouraging certain economic activity or improving equity.

Similar trade-offs exist with possible fundamental tax reforms that would move away from an income tax system to some other system, such as a consumption tax, national sales tax, or value added tax. Fundamental tax reform would most likely result in a smaller tax gap if the new system has few tax preferences or complex tax code provisions and if taxable transactions are transparent. However, these characteristics are difficult to achieve in any system and experience suggests that simply adopting a fundamentally different tax system may not by itself eliminate any tax gap.[20] Any tax system could be subject to noncompliance, and their design and operation, including the types of tools made available to tax administrators affect the size of any corresponding tax gap. Further, the motivating forces behind tax reform likely include factors beyond tax compliance, such as economic effectiveness, equity, and burden, which could in some cases carry greater weight in designing an alternative tax system than ensuring the highest levels of compliance.

[19]The tax gap for underreported individual income taxes exceeded $150 billion for tax year 2001. However, IRS does not have data on how much of this noncompliance arose because of complexity.

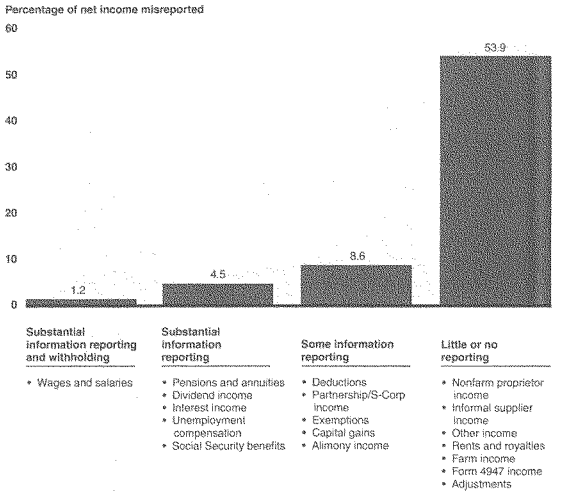
[20]For example, in a 2004 report, the National Audit Office in the United Kingdom reported on the 15.7 percent gap for the value added tax, which was introduced three decades earlier.

Providing IRS with Additional Enforcement Tools Potentially Could Improve Compliance Significantly, but Identifying and Designing Such Tools Can Be Challenging

Changing the tax laws to provide IRS with additional enforcement tools, such as expanded tax withholding and information reporting, could also reduce the tax gap by many billions of dollars, particularly with regard to underreporting—the largest segment of the tax gap. Tax withholding promotes compliance because employers or other parties subtract some or all of the taxes owed from a taxpayer's income and remit them to IRS. Information reporting tends to lead to high of compliance because income taxpayers earn is transparent to them and IRS. In both cases, high levels of compliance tend to be maintained over time. Also, because through withholding and information reporting IRS can better identify noncompliant taxpayers and prioritize contacting them by the potential for additional revenue, these tools can enable IRS to better allocate its resources. However, designing new withholding or information reporting requirements to address underreporting can be challenging given that many types of income are already subject to at least some form of withholding or information reporting, there are varied forms of underreporting, and the requirements could impose costs and burdens on third parties.

Taxpayers tend to report income subject to tax withholding or information reporting with high levels of compliance, as shown in figure 1, because the income is transparent to the taxpayers as well as to IRS. Additionally, once withholding or information reporting requirements are in place for particular types of income, compliance tends to remains high over time. For example, for wages and salaries, which are subject to tax withholding and substantial information reporting, the percentage of income that taxpayers misreport report has consistently been measured at around 1 percent over time.

Figure 1: Individual Net Income Misreporting Categorized by the Extent of Income Subject to Withholding and Information Reporting, Tax Year 2001



Source: IRS.

In the past, we have identified a few specific areas where additional withholding or information reporting requirements could serve to improve compliance:

- **Require more data on information returns dealing with capital gains income from securities sales.** Recently, we reported that an estimated 36 percent of taxpayers misreported their capital gains or losses from the sale of securities, such as corporate stocks and mutual funds.[21]

[21]GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

Further, around half of the taxpayers who misreported did so because they failed to report the securities' cost, or basis, sometimes because they did not know the securities' basis or failed to take certain events into account that required them to adjust the basis of their securities. When taxpayers sell securities like stock and mutual funds through brokers, the brokers are required to report information on the sale, including the amount of gross proceeds the taxpayer received; however, brokers are not required to report basis information for the sale of these securities. We found that requiring brokers to report basis information for securities sales could improve taxpayers' compliance in reporting their securities gains and losses and help IRS identify noncompliant taxpayers. However, we were unable to estimate the extent to which a basis reporting requirement would reduce the capital gains tax gap because of limitations with the compliance data on capital gains and because neither IRS nor we know the portion of the capital gains tax gap attributed to securities sales.

- **Requiring tax withholding and more or better information return reporting on payments made to independent contractors.** Past IRS data have shown that independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income. We have also identified other options for improving information reporting for independent contractors, including increasing penalties for failing to file required information returns, lowering the $600 threshold for requiring such returns, and requiring businesses to report separately on their tax returns the total amount of payments to independent contractors.[22] IRS's Taxpayer Advocate Service recently recommended allowing independent contractors to enter into voluntary withholding agreements.[23]

- **Requiring information return reporting on payments made to corporations.** Unlike payments made to sole proprietors, payments made to corporations for services are generally not required to be reported on information returns. IRS and GAO have contended that the lack of such a requirement leads to lower levels of compliance for small corporations. Although Congress has required federal agencies to provide information returns on payments made to contractors since 1997,[24] payments made by

[22]GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108 (Washington, D.C.: July 23, 1992).

[23]Internal Revenue Service, Taxpayer Advocate Service, *National Taxpayer Advocate 2005 Annual Report to Congress* (Washington, D.C.: Dec. 31, 2005).

[24]Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997).

others to corporations are generally not covered by information returns. The Taxpayer Advocate Service has recommended requiring information reporting on payments made to corporations,[25] and the administration's fiscal year 2007 budget has proposed requiring additional information reporting on certain good and service payments by federal, state, and local governments.[26]

In addition to improving taxpayer compliance, information reporting can help IRS to better allocate its resources to the extent that it helps IRS better identify noncompliant taxpayers and the potential for additional revenue that could be obtained by contacting these taxpayers. For example, IRS officials told us that receiving information on basis for taxpayers' securities sales would allow IRS to determine more precisely taxpayers' income for securities sales through its document matching programs and would allow it to identify which taxpayers who misreported securities income have the greatest potential for additional tax assessments. Similarly, IRS could use basis information to improve both aspects of its examination program—examinations of tax returns through correspondence and examinations of tax returns face-to-face with the taxpayer. Currently, capital gains issues are too complex and time consuming for IRS to examine through correspondence. However, IRS officials told us that receiving cost basis information might enable IRS to examine noncompliant taxpayers through correspondence because it could productively select tax returns to examine. Also, having cost basis information could help IRS identify the best cases to examine face-to-face, making the examinations more productive while simultaneously reducing the burden imposed on compliant taxpayers who otherwise would be selected for examination. As a result of all these benefits, basis reporting would allow IRS to better allocate its resources that focus on securities misreporting across its enforcement programs.

Although withholding and information reporting lead to high levels of compliance, designing new requirements to address underreporting could be challenging given that many types of income, including wages and salaries, dividend and interest income, and income from pensions and Social Security are already subject to withholding or substantial information reporting. Also, there are challenges involved with

[25]Internal Revenue Service, Taxpayer Advocate Service, 2005.

[26]Executive Office of the President, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2007.*

establishing new withholding or information reporting requirements for certain other types of income where there is extensive underreporting of income. Challenges exist because taxable income may be difficult to determine because of complex tax laws, complex transactions, or the lack of a practical and reliable third-party source to provide the information. For example, with regard to reporting securities basis information, we reported that it would be difficult for brokers to report information for some types of transactions because of complex tax laws and that representatives from the securities industry told us that a set of rules would need to be developed to establish clearly what types of transactions would be subject to any reporting requirement.

Likewise, a persistent and large part of the tax gap relates to nonfarm sole proprietor and informal supplier income.[27] As shown in figure 1, this income is not subject to information reporting, and these taxpayers misreported about half of the income they earned for tax year 2001. Although establishing withholding or information reporting requirements for these forms of income would likely improve taxpayers' compliance, practical and effective information reporting mechanisms are difficult to identify. For example, informal suppliers by definition receive income in an informal manner through services they provide to a variety of individual citizens or small businesses. Whereas businesses may have the capacity to perform withholding and information reporting functions for their employees, it may be challenging to extend withholding or information reporting responsibilities to the individual citizens that receive services, who may not have the resources or knowledge to comply with such requirements. Consequently, innovative approaches likely will be needed if tools like withholding and information returns are to be extended to cover more sources of the tax gap.

Finally, implementing tax withholding and information reporting requirements generally imposes costs and burdens on the businesses that must implement them, and, in some cases, on taxpayers. For example, expanding information reporting on securities sales to include basis

[27]Nonfarm proprietors are self-employed individuals other than farmers who should file Schedule C with their individual tax returns to report profits and losses from their businesses. Sole proprietors include those who provide services, such as doctors or accountants; produce goods, such as manufacturers; and sell goods at fixed locations, such as car dealers and grocers. Informal suppliers are sole proprietors who work alone or with few workers and, by definition, operate in an informal manner. Informal suppliers include those who make home repairs, provide child care, or sell goods at roadside stands. These taxpayers should report business profits or losses on Schedule C.

information will impose costs on the brokers that would track and report the information. Further, trying to close the entire tax gap with these enforcement tools could entail more intrusive recordkeeping or reporting than the public is willing to accept. Considering these costs and burdens should be part of any evaluation of additional withholding or information reporting requirements.

Although I have focused on information reporting and tax withholding, I want to mention one other enforcement tool that can potentially deter noncompliance, which is the use of penalties for filing inaccurate or late tax and information returns. Congress has placed a number of civil penalty provisions in the tax code. However, as with civil penalties related to other federal agencies, inflation may have weakened the deterrent effect of IRS penalties. For example, the Treasury Inspector General for Tax Administration has noted that the $50 per partner per month penalty for a late-filed partnership tax return, established by Congress in 1978, would equate to $17.22 in 2004 dollars. In its fiscal year 2007 budget, the administration has proposed expanding penalty provisions applicable to paid tax return preparers to include non-income tax returns and related documents. In addition, Congress recently increased certain penalties related to tax shelters and other tax evasion techniques.[28] Given Congress's recent judgment that some tax penalties were too low and concerns that inflation may have weakened the effectiveness of the civil penalty provisions in the tax code, additional increases may need to be considered to ensure that all penalties are of sufficient magnitude to deter tax noncompliance.

Devoting Additional Resources to Enforcement Likely Could Reduce the Tax Gap, but to What Extent Is Difficult to Predict

Devoting more resources to enforcement has the potential to help reduce the tax gap by billions of dollars in that IRS would be able to expand its enforcement efforts to reach a greater number of potentially noncompliant taxpayers. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account many factors, such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement resources, the amount of the tax gap that could be reduced depends in part on the size of any increase in IRS's budget, how IRS would manage any additional resources,

[28]American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

and the indirect increase in taxpayers' voluntary compliance that would likely result from expanded IRS enforcement.

As I previously mentioned, IRS is able to secure tens of billions of dollars in tax revenue from noncompliant taxpayers it identifies through its various enforcement programs. However, given resource constraints, IRS is unable to contact millions of additional taxpayers for whom it has evidence on potential noncompliance. With additional resources, IRS would be able to assess and collect additional taxes and further reduce the tax gap. In 2002, IRS estimated that a $2.2 billion funding increase would allow it to take enforcement actions against potentially noncompliant taxpayers it identifies but cannot contact and would yield an estimated $30 billion in revenue.[29] For example, IRS estimated that it contacted about 3 million of the over 13 million taxpayers it identified as potentially noncompliant through its matching of tax returns to information returns. IRS estimated that contacting the additional 10 million potentially noncompliant taxpayers it identified, at a cost of about $230 million, could yield nearly $7 billion in potentially collectible revenue. However, we did not evaluate the accuracy of the estimate, and as will be discussed below, many factors suggest that it is difficult to estimate reliably net revenue increases that might come from additional enforcement efforts.[30]

Although additional enforcement funding has the potential to reduce the tax gap, the extent to which it would help depends on several factors. First, and perhaps most obviously, the amount of tax gap reduction would depend in part on the size of any budget increase. Generally, larger budget increases should result in larger reductions in the tax gap. IRS prioritizes the cases of potentially noncompliant taxpayers it reviews through its enforcement programs based on factors, such as the likelihood that a taxpayer is noncompliant, the potential amount of additional taxes that could be assessed, and collection potential. As such, it is likely that IRS would begin to experience diminishing returns as it began to review additional, lower priority cases of potentially noncompliant taxpayers. Given the diminishing returns IRS would likely experience as it moves to working less and less productive cases, the amount of expected reduction

[29]Commissioner of Internal Revenue Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of IRS and the Tax System*, October 2002.

[30]There are many aspects to the overall tax gap. Thus, if the tax gap in a specific area is reduced either through congressional actions like simplifying provisions or through IRS actions, the size of the overall gap may not be reduced if other portions of the gap increase.

in the tax gap for each additional dollar of funding would decline. Further, reductions in the tax gap that could be derived from additional enforcement funding may not be immediate. The reductions may occur gradually as IRS is able to hire and train enforcement personnel.

Recently, IRS obtained some additional funding targeted for enforcement activities that it estimated will result in additional revenue. In its fiscal year 2006 budget request, IRS requested millions of dollars to expand its tax return examination and tax collection activities with the goal of increasing individual taxpayer compliance and addressing concerns raised by GAO[31] and others regarding the erosion of IRS's enforcement presence and the continued growth in noncompliance. In estimating the revenue that it would obtain from the increased funding, IRS took several factors into account, including opportunity costs because of training, which draws experienced enforcement personnel away from the field; differences in average enforcement revenue obtained per full-time employee by enforcement activity; and differences in the types and complexity of cases worked by new hires and experienced hires. IRS forecasted that in the initial year after expanding enforcement activities, the additional revenue it expects to collect is less than half the amount it expects to collect annually in later years. This example underscores the logic that if IRS is to receive a relatively large funding increase, it likely would be better to provide it in small but steady amounts.

The amount of tax gap reduction likely to be achieved from any budget increase Congress may choose to provide also depends on how well IRS can manage the additional resources. As previously mentioned, IRS does

[31]GAO issued a number of products regarding the erosion of IRS's enforcement presence and a continued growth in noncompliance. See GAO, *Internal Revenue Service: Assessment of Fiscal Year 2005 Budget Request and 2004 Filing Season Performance*, GAO-04-560T (Washington, D.C: Mar. 30, 2004); *Internal Revenue Service: Assessment of Fiscal Year 2004 Budget Request and 2003 Filing Season Performance to Date*, GAO-03-641T (Washington, D.C: Apr. 8, 2003); *Internal Revenue Service: Assessment of Fiscal Year 2003 Budget Request and Interim Results of the 2002 Tax Filing Season*, GAO-02-580T (Washington, D.C: Apr. 9, 2003); *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2003); *Compliance and Collection: Challenges for IRS in Reversing Trends and Implementing New Initiatives*, GAO-03-732T (Washington, D.C.: May 7, 2003); *IRS Modernization: Continued Progress Necessary for Improving Service to Taxpayers and Ensuring Compliance*, GAO-03-796T (Washington, D.C.: May 20, 2003); *High Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005); and our products on the tax gap mentioned earlier in this statement, GAO-06-453T, GAO-06-208T, GAO-05-753, and GAO-05-527T.

not have compliance data for some segments of the tax gap and others are based on old data. Periodic measurements of compliance levels can indicate the extent to which compliance is improving or declining and provide a basis for reexamining existing programs and triggering corrective actions, if necessary. Also, regardless of the type of noncompliance, IRS has concerns with its information on whether taxpayers unintentionally or intentionally fail to comply with the tax laws. Knowing the reasons why taxpayers are noncompliant can help IRS decide whether its efforts to address specific areas of noncompliance should focus on nonenforcement activities, such as improved forms or publications, or enforcement activities to pursue intentional noncompliance. For those portions of the tax gap that rely on old data and where IRS does not know the reason for taxpayers' noncompliance, IRS may be less able to target resources efficiently to achieve the greatest tax gap reduction at the least burden to taxpayers.

As part of an effort to make the best use of its enforcement resources, IRS has developed rough measures of return on investment in terms of tax revenue that it assesses from uncovering noncompliance. Generally, IRS cites an average return on investment for enforcement of 4:1, that is, IRS estimates that it collects $4 in revenue for every $1 of funding. Where IRS has developed return on investment estimates for specific programs, it finds substantial variation depending on the type of enforcement action. For instance, the ratio of estimated tax revenue gains to additional spending for pursuing known individual tax debts through phone calls is 13:1 versus a ratio of 32:1 for matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns. However, in addition to current returns on investment estimated being rough, IRS also lacks information on the incremental returns on investment for some enforcement programs. Developing such measures is difficult because of incomplete information on all the costs and all the tax revenue ultimately collected from specific enforcement efforts. Because IRS's current estimates of the revenue effects of additional funding are imprecise, the actual revenue that might be gained from expanding differing enforcement efforts is subject to uncertainty.

Given the variation in estimated returns on investment for differing types of IRS compliance efforts, the amount of tax gap reduction that may be achieved from an increase in IRS's resources would depend on IRS's decisions about how to allocate the increase. Although it might be tempting to allocate resources heavily toward those areas with the highest estimated return, allocation decisions must take into account diverse and difficult issues. For instance, although one enforcement activity may have

a high estimated return, that return may drop off quickly as IRS works its way through potential noncompliance cases. In addition, IRS dedicates examination resources across all types of taxpayers so that all taxpayers receive some signal that noncompliance is being addressed. Further, issues of fairness can arise if IRS focuses its efforts only on particular groups of taxpayers.

Importantly, expanded enforcement efforts could reduce the tax gap more than through direct tax revenue collection, as widespread agreement exists that IRS enforcement programs have an indirect effect through increases in voluntary tax compliance.[32] The precise magnitude of the indirect effects of enforcement is not known with a high level of confidence given challenges in measuring compliance; developing reasonable assumptions about taxpayer behavior; and accounting for factors outside of IRS's actions that can affect taxpayer compliance, such as changes in tax law. However, several research studies have offered insights to help better understand the indirect effects of IRS enforcement on voluntary tax compliance and show that they could exceed the direct effect of revenue obtained.[33]

Various Factors Should Be Considered in Devising Strategies to Reduce the Tax Gap

Although closing the entire tax gap is neither feasible nor desirable due to costs and intrusiveness, reducing the tax gap is worthwhile for many reasons, including fairness to those who are compliant and also because it is a means to improve our nation's fiscal position. Each of the three approaches I have discussed could make a contribution to reducing the tax gap, although using multiple approaches may be the most effective strategy since no one approach is likely to address noncompliance fully

[32]Two types of indirect effect are (1) the increase in voluntary compliance in the larger population resulting from examinations or other enforcement and nonenforcement actions on targeted taxpayers, and (2) the increase in voluntary compliance of the targeted taxpayer in subsequent years.

[33]Economists have estimated the indirect effect of an examination on voluntary compliance to range from 6 to 12 times the amount of proposed tax adjustments. See Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96) (Washington, D.C.: November 1996), 2, 35-36; Jeffrey A. Dubin, Michael J. Graetz and Louis L. Wilde, "The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986," *43 National Tax Journal*, (1990), 395, 396, 405; and Jeffrey A. Dubin, "Criminal Investigation Enforcement Activities and Taxpayer Noncompliance" (paper written for the IRS Research Conference, June 2004), http://www.irs.gov/pub/irs-soi/04dubin.pdf (downloaded July 1, 2005).

and cost effectively. However, in deciding on one or more of the three broad approaches to use, many factors or issues could affect strategic decisions. Among the broad factors to consider are the likely effectiveness of any approach, fairness, enforceability, and sustainability. Beyond these, our work points to the importance of the following:

- **Measuring compliance levels periodically.** Regularly measuring the magnitude of, and the reasons for, noncompliance provides insights on how to reduce the gap through potential changes to tax laws and IRS programs. In July 2005, we recommended that IRS periodically measure tax compliance, identify reasons for noncompliance, and establish voluntary compliance goals.[34] IRS agreed with the recommendations and established a voluntary tax compliance goal of 85 percent by 2009. In terms of measuring tax compliance, we have also identified alternative ways to measure compliance, including conducting examinations of small samples of tax returns over multiple years, instead of conducting examinations for a larger sample of returns for one tax year, to allow IRS to track compliance trends annually.

- **Leveraging technology.** Better use of technology could help IRS be more efficient in reducing the tax gap. IRS is modernizing its technology, which has paid off in terms of telephone service, resource allocation, electronic filing, and data analysis capability. However, this ongoing modernization will need strong management and prudent investments to maximize potential efficiencies.

- **Considering the costs and burdens.** Any action to reduce the tax gap will create costs and burdens for IRS; taxpayers; and third parties, such as those who file information returns. As discussed earlier, for example, withholding and information reporting requirements impose some costs and burdens on those that track and report information. These costs and burdens need to be reasonable in relation to the improvements expected to arise from new compliance strategies.

- **Optimizing resource allocation.** As previously discussed, developing reliable measures of the return on investment for strategies to reduce the tax gap would help inform IRS resource allocation decisions. IRS has rough measures of return on investment based on the additional taxes it assesses. Developing such measures is difficult because of incomplete data on the costs of enforcement and collected revenues. Beyond direct

[34]GAO-05-753.

revenues, IRS's enforcement actions have indirect revenue effects, which are difficult to measure. However, indirect effects could far exceed direct revenue effects and would be important to consider in connection with continued development of return on investment measures.

- **Evaluating the results.** Evaluating the actions taken by IRS to reduce the tax gap would help maximize IRS's effectiveness. Evaluations can be challenging because it is difficult to isolate the effects of IRS's actions from other influences on taxpayers' compliance. Our work has discussed how to address these challenges, for example by using research to link actions with the outputs and desired effects.

Concluding Observations

When taxpayers do not pay all of their taxes, honest taxpayers carry a greater burden to fund government programs and the nation is less able to address its long-term fiscal challenges. Thus, reducing the tax gap is important, even though closing the entire tax gap is neither feasible nor desirable because of costs and intrusiveness. All of the approaches I have discussed have the potential to reduce the tax gap alone or in combination, and no one approach is clearly and always superior to the others. As a result, IRS needs a strategy to attack the tax gap on multiple fronts with multiple approaches.

Mr. Chairman and Members of the Subcommittee, this concludes my testimony. I would be happy to answer any question you may have at this time.

Contact and Acknowledgments

For further information on this testimony, please contact Michael Brostek on (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Individuals making key contributions to this testimony include Tom Short, Assistant Director; Jeff Arkin; Cheryl Peterson; and Jeff Procak.

GAO
Accountability • Integrity • Reliability

United States Government Accountability Office
Washington, DC 20548

October 31, 2006

The Honorable Charles E. Grassley
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

On July 26, 2006, I testified[1] before the Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance at a hearing called "A Closer Look at the Size and Sources of the Tax Gap." In August 2006, you asked us to respond for the record to questions submitted by Subcommittee Chairman Kyl, Ranking Minority Member Baucus, Senators Hatch and Kerry, and you. I have enclosed our responses.

We based our responses on our work, such as recent testimonies and a report on the tax gap.[2] We conducted this work in accordance with generally accepted government auditing standards. In responding, we grouped related questions, retaining the identities of those asking a question, to minimize duplication. We separately list at the end of the enclosure those questions in which we had not done work that would produce a substantive response. If you have questions about our responses, please contact me. Key contributors to these responses include Tom Short, Assistant Director; Jeff Arkin; and Jeff Procak.

Sincerely yours,

Michael Brostek
Director, Tax Issues
Strategic Issues Team

Enclosure

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[1]GAO, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, GAO-06-1000T (Washington, D.C.: July 26, 2006).

[2]GAO, *Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions*, GAO-06-453T (Washington, D.C.: Feb. 15, 2006); *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance*, GAO-06-208T (Washington, D.C.: Oct. 26, 2005); and *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005).

ENCLOSURE ENCLOSURE

GAO RESPONSES TO QUESTIONS FOR THE
RECORD ON THE JULY 26, 2006 TAX GAP TESTIMONY

VOLUNTARY COMPLIANCE GOALS, PLANS, AND EFFORTS

1. ***(Senators Grassley and Kyl)**: Proposals to address the tax gap will be controversial, if only because the goal will be to collect more in tax revenues. Most or all efforts to address the tax gap will take time to draft properly and additional time to implement.*
   - *How soon do you think it is realistic for Congress to expect to begin seeing additional revenues as a result of efforts to address the tax gap?*
   - *What is a realistic target for voluntary compliance? Senator Baucus has suggested 90 percent and the IRS has suggested 85 percent. How much additional revenue would that translate into?*
   - *The IRS hopes to meet its target of 85 percent by 2009. Do you think that is realistic?*

Absent a specific proposal to analyze, it is difficult to predict how quickly revenues would increase as a result of efforts to address the tax gap. In general, a lag of at least a year seems likely. For instance, expanded enforcement efforts would normally require hiring and training additional staff, which could delay the inflow of revenue. Similarly, new legislated authorities for the Internal Revenue Service (IRS) generally would require time to develop regulations and related systems and processes.

We have not studied what would be a realistic target rate for voluntary compliance. The amount that would result from improving this rate depends on the size of the tax gap. Using the most recent tax gap figures for tax year 2001, IRS's estimated 83.7 percent voluntary compliance rate produced a gross tax gap of $345 billion. If this rate for 2001 had been 85 percent, the gross tax gap would have been about $28 billion less and if it had been 90 percent, the gap would have been about $133 billion less.

Since many measures to improve compliance have a lag time before affecting compliance, an 8-year period to move the voluntary compliance rate from 83.7 percent in 2001 to 85 percent in 2009, should be long enough to affect the compliance rate. However, 4 tax years have passed since 2001 and we do not know the current compliance rate. If the rate has not improved, or has fallen, achieving the 85 percent level could be challenging unless effective measures are put in place soon.

ENCLOSURE ENCLOSURE

GAO RESPONSES TO QUESTIONS FOR THE
RECORD ON THE JULY 26, 2006 TAX GAP TESTIMONY

2. ***(Senator Baucus):*** *The Committee has requested Treasury and the IRS to submit a credible, comprehensive plan by September 30, 2006, to close the tax gap.*
   - *To what extent will having a tax gap plan help to close the gap?*
   - *Are Treasury and IRS capable of developing a credible and comprehensive plan by September 30, 2006?*
   - *Describe what such a plan should look like, for example, what priorities, goals, benchmarks, and measures do you think should be included in a tax gap plan? Discuss the appropriate allocation of resources among service, enforcement, and technology as part of your response.*
   - *To what extent can existing IRS strategic and action plans regularly prepared by operating divisions and other functions be used toward developing a comprehensive tax gap plan?*
   - *To what extent can recommendations from the IRS Oversight Board, the National Taxpayer Advocate, the Government Accountability Office, the Treasury Inspector General for Tax Administration, the National Treasury Employees Union, and nongovernmental stakeholders be used toward developing a comprehensive tax gap plan?*

A data-based plan is one key to closing the tax gap. To the extent that IRS can develop better compliance data, it can develop more effective strategies to close the gap. We recently reported[3] that IRS set long-term goals for reducing the tax gap for the first time, including a goal to improve voluntary compliance to 85 percent by 2009, but that IRS did not have a data-based plan for achieving the goal.

By completing the National Research Program (NRP) project for individual taxpayers in 2001, IRS is in a better position to develop a credible and comprehensive plan. Nevertheless, developing better compliance data is challenging. IRS still lacks data on recent compliance for many parts of the tax gap, on why taxpayers do not comply, and on the effect of its activities on compliance. Therefore, any plan IRS develops will need to rely on a mix of available data and qualitative explanations for how it expects its plan to improve compliance. Regardless, developing such a plan would be useful.

On September 26, 2006, the U.S. Department of the Treasury (Treasury), Office of Tax Policy, released, *A Comprehensive Strategy for Reducing the Tax Gap*. Although we have not studied this strategy in detail, the document in general does not identify new steps that Treasury and IRS will undertake to reduce the tax gap, time frames for such steps, or explanations for how much such steps are expected to reduce the tax gap. The document said that details on such steps would be part of the fiscal year 2008 IRS budget request for IRS.

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[3]GAO, *Internal Revenue Service: Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request*, GAO-06-499T (Washington, D.C.: Apr. 27, 2006).

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The priorities, goals, allocation of resources, and other elements of a plan to close the tax gap ultimately rest on managerial judgments that should be made by IRS. IRS's plan should reflect proven performance management principles, such as focusing on results to be achieved, long-term goals, resources needed, and the effectiveness of actions taken. We have not assessed the extent to which the strategic and action plans prepared by IRS units, like operating divisions, could be used toward developing a comprehensive tax gap plan. In general, these unit plans could be useful but if IRS makes significant changes in its strategy, the plans would need to be conformed to ensure clear linkages between each unit and IRS's overall plan.

In developing its strategic plan for reducing the tax gap, recommendations and ideas offered by us and many others could be useful in developing a comprehensive tax gap plan. In the hearing before this subcommittee, suggestions included expand withholding and information reporting, obtain better data on compliance, simplify the tax code, and provide adequate service to help taxpayers comply. Regardless, IRS will need to have a multi-prong strategy that incorporates many approaches.

3. ***(Senator Baucus):*** *To what extent would raising public awareness of the importance of complying with tax laws impact the tax gap? Describe ways that raising public awareness could be achieved.*

It is reasonable to assume that raising public awareness about the importance of tax compliance is important. IRS has attempted to do so through its web site, press releases, speeches, stakeholder meetings, and other communications. However, it is not known to what extent such nonenforcement efforts have affected voluntary compliance and the tax gap. Our products have pointed to the difficulty of isolating these impacts, especially given incomplete compliance data.[4]

4. ***(Senator Kerry):*** *What concrete steps should be taken to improve voluntary compliance?*

Our July testimony points to the importance of using multiple approaches to reduce the tax gap. The approaches include simplifying tax laws, giving IRS more tools and authorities, and ensuring IRS has sufficient resources. These approaches can contribute to voluntary compliance by reducing complexity, providing relevant information, and creating incentives to comply. Our past reports also identify ways to improve compliance overall as well as for particular types of tax issues. These reports are included in a latter section on related GAO products.

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[4]GAO-05-753

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INFORMATION REPORTING

5. ***(Senators Grassley and Kyl):*** *One of the proposals put forward by the Administration is to increase information reporting on credit card transactions. Another proposal being discussed by many is the idea of asking brokers to report basis to help taxpayers more accurately report capital gains from stock sales. While this hearing is not intended to consider the merits of specific proposals, these proposals raise issues that will have to be considered in evaluating any tax gap proposal. Has the GAO considered whether credit card reporting could encourage taxpayers to move to a cash-based system to avoid having additional information given to the IRS, even if they have no intention of cheating on their taxes?*

6. ***(Senator Baucus):*** *The National Taxpayer Advocate, the GAO and others have recommended a basis reporting regime to reduce noncompliance resulting from incorrectly stated basis amounts.*
   - *Does the IRS have the ability to match basis amounts reported on an information return with basis amounts reported on a tax return?*
   - *If the IRS lacks the ability to match basis information, provide the reasons why. Explain what actions are necessary to make such matching possible and how quickly this can be accomplished.*

We are answering these questions together since both refer to a proposal on cost basis information reporting by brokers. Although we have not done work on the credit card proposal, our work on the cost basis proposal might provide some insights.

As discussed in our 2006 report,[5] IRS does not yet have the ability to match cost basis amounts because these amounts are not reported on information returns. If they were, IRS could computer match the basis amounts, assuming enough lead time and clear, uniform reporting rules. However, IRS would need to invest in its computer system to support this additional matching. The amount of investment would depend on how basis reporting was implemented. If basis were to be reported for each taxpayer transaction, IRS would need to make a greater investment than if brokers were allowed to aggregate all transactions over a tax year for reporting to IRS. We did not develop cost estimates for these options.

Basis reporting can improve taxpayer voluntary compliance in reporting their capital gains and losses from the securities they sell. In many cases, taxpayers misreported these gains or losses

[5]GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

because they did not know the basis of the securities they sold or made errors in calculating basis.

Basis reporting also would help IRS better identify noncompliant taxpayers and allocate enforcement resources. Currently, IRS receives information from brokers on the proceeds that taxpayers receive from selling securities. Without basis information, IRS cannot compute the taxable gain or a loss, and in nearly half of the cases we reviewed, IRS contacted taxpayers who appeared to have made errors but who had not erred in their basis reporting. With basis information, IRS would be better able to select the taxpayers to contact and avoid burdening compliant taxpayers.

IRS's ability to effectively match basis information depends on the ability of brokers to accurately report basis data. For example, taxpayers can choose how to report cost basis on their tax returns for securities purchased on multiple occasions. If brokers do not know the methods used, their reporting could provide a different cost basis. Many brokers also would need to incur costs to upgrade their systems to report basis. Another set of challenges to brokers includes not being able to determine basis for some securities that were (1) affected by complex tax laws, (2) purchased through another broker or from companies that issue stock, or (3) received as gifts.

We found that many of these challenges can be addressed in some fashion. For some of the challenges, making any basis reporting requirement prospective would help. For all challenges, rules would need to be developed to guide consistent reporting, particularly for securities sales that are affected by complex tax laws, and to handle the challenges from the multiple methods that taxpayers can use to report basis. To address securities purchased through other brokers, brokers would need to share basis information in a consistent manner.

We have not reviewed whether taxpayers would move to cash rather than credit transactions to avoid the aggregate credit receipt reporting proposed by the administration. Under the proposal, credit companies would report the aggregate credit purchases from a business to IRS. Although businesses may offer inducements for cash transactions, such as lower prices, customers may continue using credit to the extent they believe that they receive more benefits.

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7. ***(Senator Baucus):*** *Please provide a current list of all information returns that are matched to tax returns submitted to the IRS for the purpose of detecting unreported income. Identify additional information returns that will begin to be matched within the next 12 months.*

We have not done work recently to determine which types of information returns are matched by IRS to detect unreported income or IRS's plans for matching additional types of information returns within a year. IRS would be better able to answer these questions. Table 1 does list the types of information returns that IRS receives under the forms 1098 and 1099 series. This list does not include the forms W-2 and W-2G, which are to be used to report information on wages, salaries, and related compensation, and on gambling winnings, respectively, or other types of information returns.

Table 1: Information Returns in the Form 1098 and 1099 Series

Form	**What is to be reported**
1098	Mortgage interest (including points) received and reimbursements of overpaid interest.
1098-E	Student loan interest received.
1098-T	Qualified tuition and related expenses, reimbursements/refunds, and scholarships/grants.
1099-A	Information on the acquisition or abandonment of property that is security for debt.
1099-B	Sales or redemptions of securities, futures, commodities, and barter exchange transactions.
1099-C	Cancellation of a debt owed to a financial institution, the federal government, a credit union, and selected others.
1099-Div	Distributions that were paid on stock and liquidation distributions.
1099-G	Unemployment compensation, state and local income tax refunds, agricultural payments, taxable grants, and earnings from a qualified state tuition program.
1099-INT	Interest income.
1099-LTC	Payments under long-term care insurance contract and accelerated death benefits.
1099-MISC	• Rent or royalty payments; prizes or awards that are not for services. • Payments to crew members by owners or operators of fishing boats. • Payments to a physician or physician's corporation, or for health or medical services.

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	• Payments for services performed for a trade or business by nonemployees. • Fish purchases paid in cash for resale. • Substitute dividend and tax-exempt interest payments reportable by brokers. • Crop insurance proceeds. • Gross Proceeds paid to attorneys.
1099-MSA	Distributions from a medical savings account (MSA) or Medicare+Choice MSA
1099-OID	Original issue discount
1099-PATR	Distributions from cooperatives to their patrons.
1099-R	Distributions from retirement or profit-sharing plans, any individual retirement account (IRA), or insurance contracts, and IRA recharacterizations.
1099-S	Gross proceeds from the sale or exchange of real estate.

Source: IRS web site

TAX LAW SIMPLIFICATION

8. ***(Senators Grassley and Kyl):*** *In your testimony, you highlight several areas where Congress has chosen to influence social policies by providing tax incentives to subsidize or encourage certain activities. These include the many education tax incentives, the Earned Income Tax Credit, and tax incentives that use varying definitions of a "qualifying child." Many Senators who support keeping, and even expanding, these targeted tax benefits have complained the loudest about the tax gap.*
   - *Do you believe it would be possible to combine the education tax incentives into one or two simple education benefits? Would that benefit taxpayers, as well as improve compliance? Should Congress consider doing the same with other areas of the tax code, like the many savings incentives?*
   - *You note that the IRS estimated that for tax year 1999, losses from the Earned Income Tax Credit were $10 billion. How could Congress improve administration of, and compliance with regard to, the Earned Income Tax Credit?*

It is possible to combine the education tax incentives into simpler forms of education benefits that likely would help taxpayers as well as improve tax compliance. We have not studied how

the combining and simplifying could be done. We have reported[6] that many taxpayers make poor choices among the educational tax incentives, in part because of complexity. We also found that simplification could help reduce errors because the definition of a qualifying postsecondary education expense differed among some tax code provisions. Making definitions consistent across code provisions may reduce errors. It is also possible to combine and simply other tax preferences or incentives. However, consolidating them likely would be complicated and create winners and losers.

We have not recently made proposals to improve administration of and compliance with the earned income tax credit (EITC). IRS is in the third year of testing new approaches for administering the credit to reduce its significant overpayment rate while not adversely affecting its high participation rate. Congress may find some useful options for improving the credit's administration by reviewing the results of IRS's tests.

9. ***(Senator Hatch):*** *Mr. Brostek, you mentioned that simplifying the tax code could make a big difference in reducing the tax gap. Are there simplification steps Congress can take right now to decrease the tax gap, without waiting for major reform? In which areas do you think we could get the most "bang for the buck" in simplification?*

Tax code complexity adds to the compliance burden and creates opportunities for tax evasion. Simplification could help taxpayers to comply voluntarily with more certainty by reducing inadvertent errors from confusion. It also would limit opportunities for tax evasion by taxpayers who can misuse the complex code provisions.

We have not studied which simplification steps would produce the "most bang for the buck." The extent of tax gap reduction through tax code simplification depends on which parts of the tax system would be simplified and in what manner. In general, simplification could take the form of broadening the tax base while reducing tax rates, which could minimize incentives for not complying. This base broadening could include a review of whether existing tax expenditures are achieving intended results at a reasonable cost in lost revenue and added burden. Tax code complexity has grown as the number of tax expenditures, such as tax credits, deductions, exemptions, exclusions, deductions, and deferrals, doubled from 1974 to 2005.[7] Tax expenditures add to the tax gap if taxpayers improperly claim them.

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[6]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on the Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences,* GAO-05-684 (Washington, D.C.: July 29, 2005).

[7]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined,* GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

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CONSIDERING COSTS AND BURDENS

10. ***(Senators Grassley and Kyl):*** *Mr. Brostek, in your testimony you state that any action to reduce the tax gap will create costs and burdens for the IRS, taxpayers, and third parties. You rightly point out that these costs and burdens need to be reasonable in relation to the improvements expected to arise from new compliance strategies. In Ms. Olson's testimony, she recommends an evaluation of information reporting or withholding proposals to determine whether the likely revenue benefits outweigh the burdens the requirement would impose. Ms. Olson also made specific legislative recommendations to increase information reporting and withholding to combat the cash economy. When we and the IRS consider measures to close the tax gap, what should this type of benefit/burden analysis entail?*

A benefit/burden analysis of measures to close the tax gap could include a number of variables from IRS's perspective, taxpayers' perspective, and the perspective of third parties that may be involved. In some cases, the analysis would likely be more qualitative than quantitative. Regardless, the analysis should consider the benefits and burdens on all affected parties and weigh the benefits and burdens across the parties, considering overall whether the benefits are reasonable given the burdens.

From IRS's perspective, some benefits focus on tax revenue, such as the direct revenue collected from any new provision and the indirect revenue in the future from improved voluntary compliance. Other benefits to IRS could include reduced costs. For instance, to the extent that information reporting increases voluntary compliance, IRS may be able to redirect its enforcement resources to other areas of noncompliance. In most cases, IRS would incur some additional costs to implement new provisions to improve compliance, and these should be identified.

From a taxpayer's perspective, benefits could include reduced time, effort, or cost to determine their tax liability and enhanced willingness to voluntarily comply if taxpayers perceive that a change means more taxpayers pay their fair share of taxes. Additionally, if an option improved IRS's ability to avoid contacting compliant taxpayers, those compliant taxpayers would benefit. On the other hand, if taxpayers need to keep more records or face more complexity in determining their tax liability (which generally is unlikely with information reporting or withholding), their burdens could increase.

From a third party's perspective (i.e., those that would either withhold and remit taxes to IRS or provide information returns to IRS and taxpayers), benefits might include increased business if the change helped their customers. For instance, in our 2006 report we found that some securities brokers had moved on their own to report the cost basis of stocks sold as a

service to their customers. Generally, however, withholding and information reporting would impose some burden on third parties. In addition to weighing this against any possible increase in tax compliance, the net change in burden may be relevant. Witnesses have testified that having a third party withhold tax and provide information returns may result in a net reduction in burden, counting both the third parties and taxpayers, in some cases. In such cases, the third parties may be more efficient than taxpayers at compiling the necessary information and a relatively smaller number of third parties may need to learn complex tax rules compared to each affected taxpayer.

11. ***(Senators Grassley and Kyl):*** *Your written testimony notes that "designing new withholding or information reporting requirements to address underreporting can be challenging given that many types of income are already subject to at least some form of withholding or information reporting, there are varied forms of underreporting, and the requirements could impose costs and burdens on third parties."*
    - *Can you recommend other ideas for innovative solutions for improving information reporting or withholding that would not impose unreasonable burdens on taxpayers?*
    - *How do you recommend Congress balance the need for additional information with the need for taxpayers to not have unreasonable recordkeeping or reporting burdens imposed upon them?*

12. ***(Senator Baucus):*** *Provide an analysis of the benefits and burdens on payers, payees, and the IRS, in connection with increased information reporting and withholding requirements. Include your conclusions and recommendations concerning an appropriate balance of benefits and burdens and the impact on effective tax administration.*

We are answering these two questions together because they each focus on information reporting and tax withholding as well as balancing the benefits compared to the burdens. First, as discussed in our July testimony and recent products, we have identified areas where more withholding or information reporting could improve compliance:

- **Require more data on information returns dealing with capital gains income from securities sales.** Recently, we reported that an estimated 36 percent of taxpayers misreported their capital gains or losses from the sale of securities, and about half did so because they failed to report the securities' cost basis correctly.[8] When taxpayers sell securities through brokers, the brokers are not required to report the cost basis. Requiring such cost basis reporting could improve voluntary reporting compliance and help IRS identify noncompliant taxpayers.

[8]GAO-06-603.

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- **Requiring tax withholding and more or better information return reporting on payments made to independent contractors.** Past IRS data have shown that independent contractors report 97 percent of the income shown on information returns but only 83 percent of income that does not show. We also have identified options for improving information reporting for independent contractors, including requiring businesses to separately report the total payments to independent contractors on their tax returns.[9]

- **Requiring information return reporting on payments made to corporations.** Payments made to corporations for services are generally not subjected to information reporting, except for those from federal agencies, which has been required since 1997.

Our response to question 10 above provides a general framework for how to analyze the benefits and burdens of increased information reporting or withholding.

IRS USE OF RESOURCES/ RETURN ON INVESTMENT

13. ***(Senators Grassley and Kyl):*** *Your written testimony notes that if Congress were to provide the IRS with more funding for enforcement, the extent to which that would be helpful in reducing the size of the tax gap would depend on how the IRS manages the additional resources.*
    - *How would you rate the IRS's history or track-record of allocating resources and using additional resources efficiently?*
    - *The IRS claims that more enforcement resources will reduce the tax gap, but your testimony indicates that it is difficult to evaluate the IRS's claims for increased collections. How can Congress get a better understanding of how beneficial increased enforcement dollars would be?*
    - *Interestingly, you also note that the IRS would experience diminishing returns as collection efforts increase. How could the IRS improve its estimates on the rate of return for additional investments in resources? Without better data, it is difficult to understand where IRS and Congress should target efforts.*

14. ***(Senators Grassley and Kyl):*** *If Congress were to provide the IRS with additional funding to bolster its enforcement activities, what kind of return could we expect from that investment and when could we expect to see it?*

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[9]GAO, *Tax Administration: Approaches for Improving Independent Contractor Compliance,* GAO/GGD-92-108 (Washington, D.C.: July 23, 1992).

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We do not have a basis for rating IRS on its efficient allocation and use of resources. To some extent, IRS has taken important steps to better ensure efficient allocation and use. For example, the NRP study has provided better data on which taxpayers are most likely to be noncompliant. IRS is using the data to improve its audit selection processes in hopes of reducing the number of audits that result in no change, which should reduce unnecessary burden on compliant taxpayers and increase enforcement staff productivity (as measured by direct enforcement revenue). Nevertheless, IRS lacks some data that would help ensure that resources are used as well as possible. For example, we reported that IRS should consider alternative methods of measuring staff productivity that take into account the complexity of cases and the quality of the work done.[10]

The degree to which revenues would increase from expanded enforcement depends on many variables, such as how quickly IRS can ramp up efforts, how well IRS selects the best cases to be worked, and how taxpayers react to enforcement efforts. Estimating those revenue increases would require assumptions about these and other variables. Because actual experience is likely to diverge from those assumptions, the actual revenues increases are likely to differ from the estimates. The lack of reliable key data compounds the difficulty of estimating the likely revenues. To the extent possible, obtaining better data on key variables would provide a better understanding of the likely results with any increased enforcement resources.

One key variable is the extent to which increased enforcement induces taxpayers to voluntarily comply. It is widely believed that increased enforcement deters tax noncompliance. Although relatively little research exists, available research suggests that such indirect revenue effects could be much larger than the direct revenue effects from enforcement and could differ widely depending on the type of IRS enforcement action.[11] Developing more definitive estimates of the indirect effects of enforcement actions is extremely challenging but is important for making better decisions on the allocation of IRS's efforts.

Another key variable in estimating revenues from enhanced enforcement is the direct revenue from pursuing the "next best case." Accordingly, it is the marginal revenue gain from these cases that matters in estimating the direct revenue from expanded enforcement. Although IRS

[10]GAO, *Tax Administration: IRS Can Improve Its Productivity Measures by Using Alternative Methods,* GAO-05-671 (Washington, D.C.: July 11, 2005).

[11]IRS enforcement programs have an indirect effect through increases in voluntary tax compliance among taxpayers receiving enforcement contacts or other taxpayers who know about these contacts. The magnitude of these indirect effects is not known because of the challenges in measuring compliance and accounting for factors beyond IRS actions. Studies have indicated that the indirect revenue effects could be as much as 6 to 12 times the proposed tax assessments from examining tax returns.

has developed some rough estimates of the marginal return of direct revenue, those estimates have limitations. In part, IRS does not have sufficiently reliable data on the cost of enforcement efforts and the actual tax collections, as opposed to tax assessments, from differing enforcement efforts.

Actual tax collections from enforcement efforts can vary substantially from tax assessments made through enforcement. Several years can elapse after IRS assesses taxes before actual tax collections occur and the amounts collected can vary by the type of tax or taxpayer involved. In a 1998 report, we found that five years after taxes were assessed against individual taxpayers with business income, 48 percent of the assessed taxes had been collected whereas for the largest corporate taxpayers 97 percent of assessed taxes had been collected.[12] We recommended that IRS develop ways to track and report, over a reasonable number of years, the collections that result from assessments for specific types of audits and that IRS track the direct staff costs of collecting tax assessments for the audits.

As for providing additional enforcement funding, our testimony indicated that IRS has millions of tax returns that have indications of noncompliance but that IRS lacks the resources to work. Additional resources would enable IRS to work the cases and collect additional taxes to some extent. Even so, tax gap reductions from such additional efforts may not be immediate. If IRS invests the resources into hiring more enforcement staff, the reductions may occur gradually as IS is able to hire and train the staff. IRS has estimated that the additional revenue in the initial year after expanding enforcement activities is about half the amount it expects to collect in later years because of various "start-up factors."

15. ***(Senator Baucus):*** *Provide estimates of the average return on investment (ROI) for each additional dollar appropriated to the IRS for enforcement, taxpayer service, and for any purpose (relative to the FY 2006 appropriation). Please include both the direct and indirect effects on revenues. Indirect effects should include both the impact on taxpayers whose returns or parts of returns are not examined or who do not receive service, and the impact in subsequent years on taxpayers whose returns or parts of returns are examined or who do receive service.*

As discussed above, IRS data on the direct return on investment are quite rough and quite speculative for the indirect effects. We have not attempted to compute such returns for enforcement, taxpayer service, or other appropriation increases.

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[12]GAO, *Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs,* GAO/GGD-98-128 (Washington, D.C.: June 23, 1998).

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16. ***(Senators Grassley and Kyl):*** *Mr. Brostek, given that we do not have reliable information on many portions of the tax gap as well as on such things as the indirect effect of enforcement activities on voluntary compliance and the distinction between inadvertent mistakes and deliberate misreporting, how should we and the IRS make decisions on addressing the tax gap? How could the IRS improve its data on why some taxpayers are noncompliant and what steps would be more effective at improving compliance—more enforcement or better taxpayer services?*

Decisions on addressing the tax gap should be based on the best available information. Evidence is strong that withholding and third-party information reporting are associated with high levels of compliance. Further, these tools help IRS to better use its resources. Evidence is also consistent that the largest contributor to noncompliance is underreporting of income and that much of this underreporting is by individuals with business income.

When data are insufficient, it becomes even more important to clearly describe the rationale for any planned steps to improve compliance. In outlining such steps, IRS should present its best evidence about the targeted compliance problem and its logic for believing a planned step is likely to be effective. This enables others, like Congress, to weigh the evidence and make their own judgments. To improve decision making, IRS should gather sufficient information to evaluate whether its steps work as intended.

Finally, our previous work has pointed to other factors and actions to consider.[13] First, closing the entire tax gap is neither feasible nor desirable due to costs and intrusiveness. Second, reducing the tax gap is worthwhile for many reasons beyond tax gap reduction, including fairness to those who are compliant. Third, using multiple approaches may be the most effective strategy since no one approach is likely to address noncompliance fully and cost effectively.

17. ***(Senators Grassley and Kyl):*** *Mr. Brostek, the IRS points to resource challenges as impeding the type of compliance studies that are needed to better understand the size and nature of the tax gap. What observations do you have on these resource challenges?*

Although NRP-style compliance studies do indeed require a significant investment of IRS resources, this cost should not be discussed in isolation from the benefits. First, even though NRP-style studies are likely to result in fewer tax assessments than normal audits, such studies do identify noncompliance and IRS does assess taxes on those found to be noncompliant.

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[13]GAO-05-753 and GAO-06-1000T.

But, much more important is the future benefits. In making its case to Congress to undertake the individual income tax NRP study, IRS noted that its tools for selecting taxpayers for audits had become obsolete and the percentage of audits in which IRS proposed no change in tax liability had increased. This meant that IRS was not realizing as high a return as possible from its audits and was burdening more compliant taxpayers. By incorporating the NRP results into its audit selection formulas, IRS expects to reduce the number of audits that result in no change in tax liability and increase the average tax assessment amounts. If these results occur, the benefits in future years should exceed the up-front cost of having done the NRP study.

Further, NRP-like studies in the past have also lead at times to regulatory or statutory changes that address sources of noncompliance. These benefits also should be accounted for in judging whether the "cost" of NRP is worthwhile.

18. ***(Senator Hatch):*** *Mr. Brostek, what do you think of the IRS's National Research Program? Is it effective or should it be replaced with something else?*

We have supported development of a compliance measurement tool such as NRP and have reported on its development. Recognizing the need for better compliance data, IRS implemented NRP for tax year 2001. The NRP helped IRS improve its estimate of the tax gap estimate for 2001 and results are being incorporated into formulas for selecting taxpayers for examination.[14] We have not studied how well IRS implemented the NRP study design or used NRP data to improve its efforts to address the tax gap. Although care must be taken to do future NRP studies as efficiently as possible, with minimum burden on taxpayers, such studies need to be done at least periodically so IRS can better understand evolving compliance problems, better target its service and enforcement efforts, determine its resource needs, and identify changes needed to promote high levels of voluntary compliance.

19. ***(Senator Baucus):*** *TIGTA report #2006-50-077, "Some Concerns Remain about the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections," found that assumptions and methodologies used by the IRS to calculate the 2001 tax gap may be faulty. To what extent is the reliability of the IRS's estimates of the tax gap compromised by faulty assumptions and methodologies?*

Our July 2005 report on the tax gap[15] raised concerns about compliance data that were old or missing and about some of the methodologies as well as the inherent difficulties in measuring much of the tax gap. Our report did not attempt to measure the extent to which IRS's

[14]For a discussion about data sources and methodologies used in estimating the tax gap, see GAO-05-753.

[15]GAO-05-753.

estimates were faulty but did discuss which parts of the estimates suffer from more uncertainty than other parts. We also recommended that IRS develop plans to periodically measure tax compliance for areas that have been measured previously; study ways to cost effectively measure compliance for other components of the tax gap that have not been measured; and regularly collect complete, accurate, and consistent data, to the extent possible, on the reasons that taxpayers do not comply.

20. ***(Senator Baucus):*** *Identify and discuss the:*
    - *five primary causes of the tax gap*
    - *five primary impediments to voluntary compliance.*
    - *extent IRS is directing its resources toward the five primary causes of the tax gap, and*
    - *measures to use to determine whether the IRS's efforts constitute the optimal use of resources to improve voluntary compliance and close the tax gap.*

IRS does not have recent compliance data for the entire tax gap, including full information on the top five causes of the tax gap and top five primary impediments. However, this Committee has asked us to analyze the recently completed database for the NRP audits done on individual tax returns filed for tax year 2001 with the intent of gaining some insights on these causes and impediments to the extent that IRS's data are deemed reliable.

As for the extent to which IRS is directing its resources to the five top causes of the tax gap, our work for the July 2005 report noted that IRS's data on the reasons for noncompliance were weak and that its compliance plans and efforts were not directed to the causes of the tax gap, but rather to tax noncompliance in general.

As noted in response to a question above, on September 26, 2006, the U.S. Department of the Treasury, Office of Tax Policy, released *A Comprehensive Strategy for Reducing the Tax Gap*. Although we have not studied this strategy in detail, the document in general does not identify new steps that Treasury and IRS will undertake to reduce the tax gap, time frames for such steps, or explanations for how much such steps are expected to reduce the tax gap. The document said that details on the steps that would be taken to address the tax gap would be part of the fiscal year 2008 IRS budget request.

BUSINESS INCOME UNDERREPORTING

21. ***(Senator Grassley and Kyl):*** *Mr. Brostek, we've heard from all our panelists this afternoon that addressing the tax gap will involve increased enforcement, more information reporting, and tax code simplification. According to the IRS's estimates, the*

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largest chunk of the tax gap -- $109 billion -- is from underreported net business income by individuals.

- *Can you please explain the roles that enforcement, information reporting, and tax code simplification might play in reducing this component of the tax gap?*
- *Are there any other measures that might address this component?*

22. ***(Senator Kerry):*** *Is the underreporting of income the biggest contributor to the tax gap and if so, are there ways to significantly improve reporting that are not burdensome and costly for small businesses?*

Our July testimony provides our views on the roles that enforcement, information reporting, and tax code simplification play in reducing the tax gap overall. Those same roles apply to the $109 billion tax gap in 2001 from business income underreporting.

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OTHER TOPICS

23. ***(Senator Kerry):*** *What percent and amount of the tax gap can be contributed to the earned income tax credit (EITC)? What percent of audits is conducted on EITC filers?*

Based on IRS's estimates, the tax gap for EITC was about $10 billion in 1999. We have not recently studied what percentage of audits address the EITC issue, but IRS officials told us during June 2006 that IRS does about 300,000 annual audits of this issue. IRS should be able to provide the exact numbers for recent years.

24. ***(Senator Kerry):*** *What percent of audits are conducted on high-income taxpayers?*

According to IRS's data book for fiscal year 2005, IRS audited about 1.22 million individual income tax returns. Of these, about 219,000 returns--about 18 percent--reported at least $100,000 in total positive income by individuals without significant business income (about 138,000 returns) or in total gross receipts for those with significant business income (about 81,000 returns) as self employed taxpayers (including farmers). For context on these audit numbers, individual taxpayers who reported at least $100,000 in total positive income or total gross receipts filed about 14 million individual tax returns of the about 130.6 million income returns filed, or about 10.7 percent.

25. ***(Senator Hatch):*** *Last summer, we heard a great deal about the problem of erroneous taxpayer identification numbers (TINs) on W-2s. For example, for the years 1995 through 1998, the IRS received about 9.6 million Forms 1099-MISC, reporting approximately $204 billion in non-employee compensation that either did not contain a TIN or had a TIN that did not match IRS records. Over 600 came from the Department of Defense. One company filed 131,991 unmatchable W-2s over five years, reporting more than $524 million in wages paid to unknown taxpayers. My question is whether we are making any progress here. Is the Social Security Administration or GAO or anybody else doing something to combat this problem?*

Commissioner Everson testified before the Subcommittee on Oversight, House Committee on Ways and Means on February 16, 2006, about the various federal agencies involved in dealing with mismatched names and social security numbers (SSN) on the Form W-2. That testimony also described IRS progress made and barriers faced in dealing with the mismatches for Form W-2.

We have issued reports on mismatched names and SSNs for information returns, such as the Forms W-2. We are starting a study at the request of this committee involving the tax noncompliance among sole proprietors, including problems with information reporting for them.

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Further, our August 2004 report[16] on misreported SSNs on Forms W-2 noted that IRS did not have a dedicated program for penalizing employers who file Forms W-2 with inaccurate SSNs and IRS had no record of ever penalizing an employer. During 2004, IRS was reviewing 100 "egregious" employers whose Forms W-2 had inaccurate SSNs to determine whether to implement a penalty program. We recommended that IRS consider options for revising the criteria that trigger waivers of these penalties and consult with other agencies that could be affected before issuing any regulations.

26. ***(Senator Baucus):*** *Dr. Mazur estimated that 7 million immigrants are on U.S. payrolls, and 75% of them pay employment taxes. Dr. Mazur indicated that the number of these individuals using stolen or false social security numbers is unknown.*
    a. *IRS Publication 4535 advises individuals to respond immediately to an IRS notice in the event of a tax matter resulting from identity theft. Describe the actions taken by IRS officials when the IRS is notified by an individual that his/her identity has been stolen, resulting in a tax matter. Provide applicable Internal Revenue Manual sections or other internal guidance describing these procedures.*
    b. *Describe the coordination between the IRS and TIGTA to determine the jurisdiction of stolen or fictitious identity cases that impact tax administration. Identify any impediments to such coordination, including IRC section 6103 disclosure issues.*
    c. *How many stolen or fictitious SSN cases have been reported to the IRS during the last five years? How does the IRS track this figure?*
    d. *How many stolen or fictitious SSN cases have been worked by the IRS during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.*
    e. *How many stolen or fictitious SSN cases have been reported to TIGTA during the last five years? How does TIGTA track these cases?*
    f. *How many stolen or fictitious SSN cases have been worked by TIGTA during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.*
    g. *In the event of a recurring problem, i.e., the same SSN is claimed by more than one taxpayer for more than one year, is the case worked every year or resolved for all future years?*
    h. *Provide the Full Time Equivalents (FTEs) spent on ID theft cases during the last five years by the IRS and TIGTA.*

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[16]GAO, *Tax Administration: IRS Needs to Consider Options for Revising Regulations to Increase the Accuracy of Social Security Numbers on Wage Statements,* GAO-04-712 (Washington, D.C.: Aug. 31, 2004).

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i. *To what extent do staffing levels impact on the IRS's, and TIGTA's, ability to work identify theft cases?*

We have not done work on most of these issues but have done some general work on what IRS does when identify theft appears to have occurred. IRS urges individuals who think their identities have been stolen and used inappropriately for tax purposes to call IRS. If an individual has an ongoing issue related to identity theft that has not been resolved through normal IRS processes or has suffered or is about to suffer a significant hardship from administration of the tax laws, IRS urges the individual to contact the National Taxpayer Advocate. IRS said that it has controls to protect tax information and has established an Identity Theft Program Office. As one of the largest repositories of personal data, IRS is often at the center of concerns over the sharing of data. Because the confidentiality of tax data is considered crucial to voluntary taxpayer compliance, IRS is restricted under Section 6103 of the Internal Revenue Code from sharing taxpayer data, except in very limited circumstances when the requesting agency makes a compelling case that the information is needed and cannot be reasonably obtained from another source.

27. ***(Senator Baucus):*** *The National Taxpayer Advocate testified that examiners participating in the IRS's National Research Program reported that only 3% of the issues resulting in a change in tax liability were the result of "deliberate or intentional" acts, 27% of adjusted issues were identified as computational errors, and 67% were reported to be inadvertent mistakes.*
   - *To what extent are the examiners' figures reliable?*
   - *Dr. Mazur and Mr. Brostek commented that it was difficult to tell whether errors that studies had classified as simple mistakes were truly inadvertent. Please provide examples of studies that demonstrate this point.*
   - *What factors could influence an examiner's characterization of the causes of an adjustment to an issue?*
   - *What training do examiners receive to identify and characterize the causes of noncompliance?*
   - *For purposes of the NRP study, provide the definitions of deliberate, intentional, and inadvertent.*
   - *Please provide an example of the document completed by examiners that contains this information.*
   - *To what extent is an examiner required to consider penalties if he/she characterizes the cause of an adjustment to be the result of a deliberate or intentional act?*

In general, IRS officials should be in a better position to answer most parts of this question. However, regarding the reliability of examiners' judgments about whether noncompliance was deliberate or intentional, or inadvertent, the basic difficulty is that these judgments require IRS

personnel to determine a taxpayer's intent. Although in some situations a taxpayer's intent may be reasonably clear, such as when an item of income is simply recorded on the wrong line of a return, in many situations the taxpayer's intent likely is subject to considerable uncertainty.

QUESTIONS THAT FALL OUTSIDE THE SCOPE OF OUR RESPONSES

We do not have completed work that enables us to answer certain questions that were posed. We understand that the questions were also posed to other witnesses from IRS, TIGTA, and the National Taxpayer Advocate and hope they will be able to provide responses based on their expertise and work. Those questions follow, organized by the Senators who asked them in the letter requesting our responses.

From Senators Grassley and Kyl:

- 1993 Report: I think it is interesting that a 1993 report by the Treasury Department and the Office of Management and Budget determined that "enforcement is the most costly option and delivers only limited revenue." Do you agree? That same report found that "methods to increase voluntary compliance are less costly but more burdensome to taxpayers." Is this referring to increased reporting and/or withholding? Or to other options? Lastly, that report made several other recommendations that might still be instructive. Perhaps the most interesting revelation is TIGTA's comment that they were unable to determine if the report's recommendations were implemented. Do you know if any of the recommendations were implemented?

- Under current law, the IRS is required to keep accounts receivable on the books for te ten years -- and thus amounts that it knows are uncollectible cannot be written off for that period of time. Would it make sense to reduce that to a shorter length of time so that we have a truer picture of the accounts receivable inventory -- e.g., six years?

From Senator Baucus:

- Identify and discuss the five primary burdens of taxpayers in meeting their tax obligations.

- Identify and discuss the five primary concerns of IRS external stakeholders.

- Identify and discuss the five most significant impediments to the IRS's efficiency and effectiveness. What is the IRS doing to eliminate or mitigate these impediments?

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- Identify and discuss the five most significant resource challenges facing the IRS.
- Identify and discuss the five primary impediments to delivering top quality customer service.
- Identify and discuss the five primary technological impediments the IRS is experiencing.
- Identify and discuss the five primary collection impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?
- Identify and discuss the five primary examination impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?
- To what extent will the high percentage of retirement-eligible employees at the IRS impact the tax gap within the next five years? 10 years?
- What is the IRS doing to retain experienced employees eligible for retirement?
- Describe the IRS's plans to transfer knowledge, skills and abilities from experienced workers to new workers, and to hire workers to replace employees who retire.
- Please provide the results of the most recent "TIPS" (Trends, Issues, Problems) reports for each IRS operating division and major function.
- Please provide the most recent Strategic Action Plans for each IRS operating division and major function.
- Provide examples of instances when the Treasury and the IRS have developed plans in response to unanticipated circumstances or legislation containing effective dates very soon after the date of enactment.
- To what extent do delays in issuing regulations or other guidance, or delays in deciding a legal position on an issue, impact the tax gap? Comment on the appropriate nexus between expedient tax administration and the "right" legal answer to a tax issue, e.g., is it preferable to issue guidance more quickly that meets the needs of 99% of taxpayers rather than deferring guidance for an extended time in order to address the remaining 1% of taxpayers with unique or unusual circumstances?

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- The IRS website provides phone numbers and addresses for local IRS offices. Taxpayers are advised they can call a phone number, leave a message, and the call will be returned by the IRS within 2 business days. The Committee recently tested the level of service to taxpayers calling the IRS. Calls to 25 of these sites yielded only 18 returned phone calls, a 28% failure rate. Of the 18 responses, only one IRS caller suggested visiting the IRS website for information. The most prevalent recommendation by the IRS responders was for the caller to visit the local IRS office for assistance. IRS leadership explains proposed reductions in taxpayer assistance center hours and services are justified because of increased web services.

    - Explain why 28% of the phone calls would not be returned.
    - Explain the apparent disconnect between IRS leadership and front-line employees regarding the use of the IRS website as an information resource for taxpayers.

- TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," found that while the IRS has increased its examination coverage rate of high-income taxpayers, the increased coverage largely is due to correspondence examinations. TIGTA reported assessments of $1.4 billion on taxpayers who failed to respond to the IRS during correspondence exams, however, 71% of these assessments remained uncollected after almost 2 years. Given these results, is it efficient to use IRS resources to conduct a correspondence exam that can be ignored by a taxpayer without apparent consequence?

- TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," indicates that IRS management officials say they are working on a plan to better identify high-income tax returns for examination, *including placing less emphasis on non-filers*. TIGTA report #2004-30-127, "The Return Delinquency Notice Program Could Be Used More Effectively to Promote Filing Compliance and Reduce the Tax Gap," found that the number of potential individual non-filer cases increased from 6.1 million in 1994 to 8.9 million in 2001, but that IRS resources assigned to these cases had declined. TIGTA observed that the ability of the Return Delinquency Notice Program to effectively promote filing compliance has been significantly affected. TIGTA estimated at least $1 billion in taxes was foregone as a result.

    - Explain the IRS's decision to place less emphasis on high-income nonfilers in light of these TIGTA reports.
    - What impact would deemphasizing high-income nonfilers have on tax administration and the tax gap?

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- Why do so many high-income taxpayers ignore correspondence audits? Is this true for other taxpayer groups, as well?
- What can the IRS do to increase taxpayer response to correspondence audits?
- How can the IRS collect tax deficiencies resulting from correspondence audits sooner?

- TIGTA report #2006-40-067, "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program," found that at least 47 Taxpayer Assistance Centers are understaffed. What plans does the IRS have to ensure that TACs are staffed commensurately with taxpayer needs?

- The May 27, 2006 IRS Filing Season Data reports 3,449,641 field assistance walk-in contacts, an 11.1% decrease from 2005. Describe how this count is taken. Are taxpayers who desire services not offered by the TAC included? Are taxpayers who appear outside the hours of service or when the TAC is closed for lunch counted?

- Dr. Mazur stated in his testimony that "most countries would be thrilled to have a voluntary compliance rate of almost 84 percent." Please provide the voluntary compliance rates for countries in the European Union and/or the G-8. To the extent possible, present the rates in a format that is comparable to US tax gap measurements, e.g., "apples to apples", including breakdowns by the type of taxpayer and the type of tax.

- To what extent is it feasible for the IRS to include a "marker" on its Master File system to denote that a Form 8886 has been filed?

- For FY 2005, please provide the following data about the IRS's Automated Collection System (ACS). TDA refers to Taxpayer Delinquent Accounts and TDI refers to Taxpayer Delinquency Investigations.

  - Number of TDAs closed during the year, and length of time in inventory
  - Number of TDAs in inventory at the end of the year, and average length of time in inventory
  - Number of TDIs closed during the year, and length of time in inventory
  - Number of TDIs in inventory at the end of the year, and average length of time in inventory
  - Total collections, collections per case, collections per FTE
  - Accounts written off, average length of time in inventory, dollar value of the accounts written off, and criteria used to decide whether to write-off

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- Number of incoming phone calls and the number of calls answered
- Number of outgoing calls
- To what extent do staffing levels and technological capacity impact the ability to process calls and work the accounts?
- Number of cases in the Collection Queue, average length of time in inventory, and the dollar value in the queue
- Queue accounts written off, average length of time in inventory, dollar value of the accounts written off, and criteria used to decide whether to write-off
- To what extent will the private debt collectors be assigned inventory from ACS and the Queue?

From Senator Kerry:

- In a new report, the Treasury Inspector General for Tax Administration has criticized lapses in IRS security measures to protect against unauthorized access to returns. What is being done to address this?

- In a new report, the Treasury Inspector General for Tax Administration indicates that 70 percent of the assessments on high-income taxpayers have not been collected. Why has this happened and what can be done to improve collection rates?

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RELATED GAO PRODUCTS

*Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches, GAO-06-*1000T (Washington, D.C.: July 26, 2006).

Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed, GAO-06-603 (Washington, D.C.: June 13, 2006).

Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting, GAO-06-851T, June 13, 2006.

Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions. GAO-06-453T. Washington, D.C.: February 15, 2006.

Tax Gap: Multiple Strategies, Better Compliance Data, and Long-term Goals Are Needed to Improve Taxpayer Compliance. GAO-06-208T. Washington, D.C.: October 26, 2005.

Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap. GAO-05-753. Washington, D.C.: July 18, 2005.

Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies. GAO-05-527T. Washington, D.C.: April 14, 2005.

Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns. GAO-04-74. Washington, D.C.: December 5, 2003.

Tax Administration: IRS Should Continue to Expand Reporting on Its Enforcement Efforts. GAO-03-378. Washington, D.C.: January 31, 2003.

Tax Administration: IRS Can Improve Information Reporting for Original Issue Discount Bonds. GAO-GGD-96-70. Washington, D.C.: March 15, 1996.

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Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed. GAO/GGD-94-123. Washington, D.C.: May 11, 1994.

Tax Administration: Computer Matching Could Identify Overstated Business Deductions. GAO/GGD-93-133. Washington, D.C.: August 13, 1993.

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Tax Administration: Information Returns Can Improve Reporting of Forgiven Debts. GAO/GGD-93-42. Washington, D.C.: Feb.17, 1993.

Tax Administration: Overstated Real Estate Tax Deductions Need to Be Reduced. GAO/GGD-93-43. Washington, D.C.: January 19, 1993.

Tax Administration: Federal Agencies Should Report Service Payments Made to Corporations. GAO/GGD-92-130. Washington, D.C.: September 22, 1992.

Tax Administration: Approaches for Improving Independent Contractor Compliance. GAO/GGD-92-108. Washington, D.C.: July 23, 1992.

Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs. GAO/GGD-91-118. Washington, D.C.: September 27, 1991.

IRS Needs to Implement a Corporate Document Matching Program. GAO/T-GGD-91-40. Washington, D.C.: June 10, 1991.

Tax Administration IRS Can Improve Its Program to Find Taxpayers Who Underreport Their Income. GAO/GGD-91-49. Washington, D.C.: March 13, 1991.

Tax Administration: Expanded Reporting on Seller-financed Mortgages Can Spur Tax Compliance. GAO/GGD-91-38. Washington, D.C.: March 29, 1991.

IRS' Compliance Programs to Reduce the Tax Gap. GAO/T-GGD-91-11. Washington, D.C.: March 13, 1991.

IRS Can Use Tax Gap Data to Improve Its Programs for Reducing Noncompliance. GAO/T-GGD-90-32. Washington, D.C.: April 19, 1990.

Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers. GAO/GGD-89-107. Washington, D.C.: September 25, 1989.

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Tax Administration: Missing Independent Contractors' Information Returns Not Always Detected. GAO/GGD-89-110. Washington, D.C.: September 8, 1989.

Tax Administration: IRS' Efforts to Establish a Business Information Returns Program. GAO/GGD-88-102. Washington, D.C.: July 22, 1988.

The Merits of Establishing a Business Information Returns Program. GAO/T-GGD-87-4. Washington, D.C.: March 17, 1987.

STATEMENT OF

THE HONORABLE J. RUSSELL GEORGE
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION
before the
U.S. SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

"A Closer Look at the Size and Sources of the Tax Gap"
July 26, 2006

Introduction

Chairman Kyl, Ranking Member Jeffords, and Members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss the size and sources of the tax gap, as well as some opportunities for closing the tax gap.

The objective of our tax system is to fund the cost of government operations. The Internal Revenue Service (IRS) attempts to meet this objective by implementing a tax system that provides adequate funding for the Federal Government and is fairly applied to all taxpayers. But, as we know, the system has failed to capture a significant amount of the tax revenue that is owed, which we call the tax gap. The IRS defines the tax gap as "the difference between what taxpayers are supposed to pay and what is actually paid."[1]

It is worth noting, that if we were to capture the estimated annual tax gap, it would offset the projected fiscal year (FY) 2006 budget deficit of $296 billion and give us a surplus of approximately $50 billion. Because the tax gap poses a significant threat to the integrity of our voluntary tax system, one of my top priorities for TIGTA is to identify opportunities for improvements to the IRS' tax compliance initiatives.

Similar to nearly all other Federal agencies, the IRS has limited resources to apply to the objectives it seeks to achieve. Nevertheless, the IRS must face the challenge of trying to increase voluntary compliance and reduce the tax gap.

When I testified on the tax gap last year, I reported that some of the most challenging barriers to closing the tax gap are tax law complexity, incomplete information on the tax gap and its components, and reduced IRS enforcement resources. These same barriers exist today. To an extent, a portion of the tax gap can be closed through more effective enforcement and a commitment of additional enforcement resources. A significant portion of the gap, however, may not be amenable to traditional examinations and audits. Other means might better address that portion, such as tax law simplification and increased third-party reporting. Some of TIGTA's more significant findings and

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[1] *Hearings on Bridging the Tax Gap Before the Senate Committee on Finance*, 108th Cong. (2004) (statement of Mark Everson, Commissioner of Internal Revenue).

recommendations to improve tax administration and help the IRS reduce the tax gap are presented later in my testimony.

The Tax Gap: Its Size and Sources

The IRS describes the tax gap as having three primary components — unfiled tax returns, taxes associated with underreported income on filed returns, and underpaid taxes on filed returns.[2] Within the underreported income component, the IRS has further delineated specific categories of taxes, such as individual, corporate, employment, estate, and excise taxes.

In 2006, the IRS updated its estimate of the tax gap, which had been based on data for tax year (TY) 1988. The new estimate was based on data obtained from the National Research Program (NRP) for TY 2001 individual income tax returns.[3] Data from the NRP were used to update the 2001 tax gap figures. The IRS developed a chart called the tax gap map to graphically depict the gross tax gap for TY 2001, its components, and their relative sizes. The first iteration of the map was completed prior to the first phase of the NRP.

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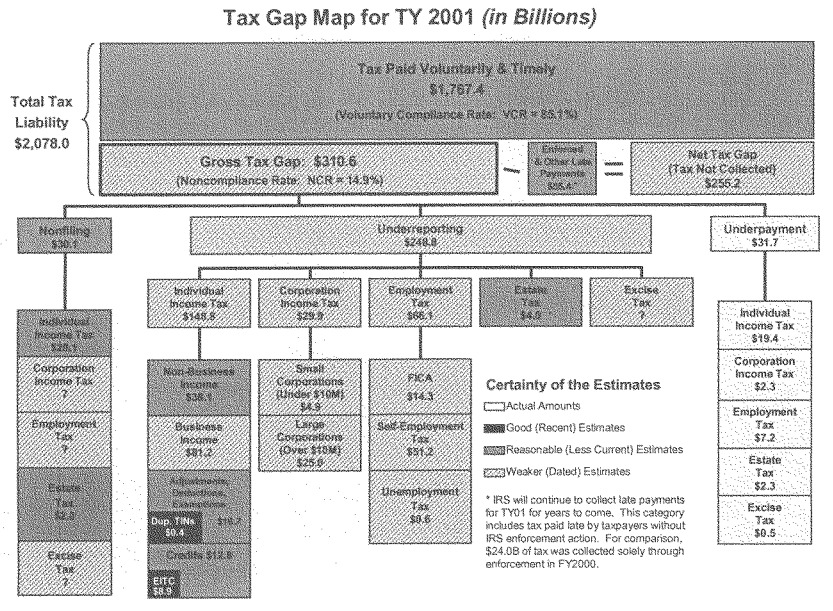
[2] This definition and the associated categories have evolved over time. IRS tax gap estimates in 1979 and 1983 included unpaid income taxes owed from illegal activities such as drug dealing and prostitution. That practice was discontinued in the 1988 estimate. Reasons given for excluding are 1) the magnitude of the illegal sector is extremely difficult to estimate; and 2) the interest of the government is not to derive revenue from these activities, but to eliminate the activities altogether. Earlier tax gap figures such as those for 1965 and 1976 only included underreporting. While figures for more recent years (1992, 1995, 1998 and 2001) are more comparable, they are essentially the same estimates adjusted for the growth in the economy. Thus, comparing the figures does not show real growth in the tax gap. Lastly, comparisons among years are not done in constant dollars, so any real growth in the tax gap cannot be determined through this IRS data.

[3] Prior to the National Research Program, tax gap estimates were based on the results of the IRS Taxpayer Compliance Measurement Program (TCMP), which was a systematic program of tax return examinations conducted to facilitate the compilation of reliable compliance data. The last TCMP process involved TY 1988 individual income tax returns.

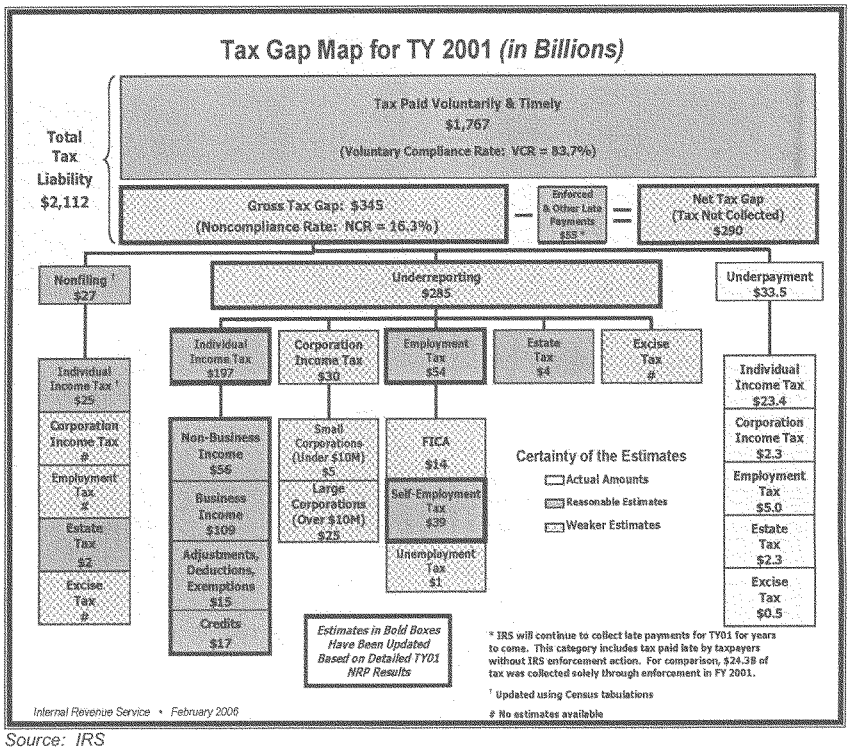
Figure 1: IRS Tax Gap Map Before the National Research Program



Source: IRS

The map attributes various certainties to the tax gap estimates representing the IRS' confidence in the figures based on the quality and age of the estimates. Subsequent to the NRP, the map was updated with preliminary figures in March 2005. After refinement of the NRP data, a third iteration was issued in February 2006. Figure 2 shows the most recent version of the tax gap map.

Figure 2: IRS Tax Gap Map <u>After</u> the National Research Program



Source: IRS

As shown in the preceding tax gap maps, the IRS' preliminary TY 2001 gross tax gap estimate for individual, employment, corporate, and other taxes was $310.6 billion with a voluntary compliance rate (VCR) of 85.1 percent. However, the most recent gross tax gap estimate is $345 billion with a VCR of 83.7 percent based on updates using the NRP data.

In any discussion about whether a specific VCR goal can be met, the logical starting point would be an assessment of the reliability of the measurement data. In April 2004, Senator Baucus called for a 90 percent VCR by the end of the decade. Based upon the best information the IRS had available as of February 2006, the gross tax gap for TY 2001 was approximately $345 billion and the VCR was approximately 83.7 percent. Assuming the current IRS tax gap and VCR were complete and accurate, the 90 percent compliance target would present major challenges to tax administration. For example,

assuming that in TY 2010 the total tax liability is the same as it was in TY 2001, to reach a level of 90 percent voluntary compliance, noncompliant taxpayers would have to timely and voluntarily pay an additional $134 billion.[4]

In April 2006, my staff reported results of a review to determine whether the IRS' compliance efforts and strategies will enable it to achieve a 90 percent VCR by 2010.[5] In all three compliance areas across the major tax gap segments, TIGTA has concerns about whether the tax gap projections are complete and accurate. TIGTA's primary concerns are described in the areas of nonfiling, underreporting, and estimated payments that result in the difference between the gross and net tax gaps.[6]

Nonfiling

Prior to the NRP, the IRS estimated the nonfiling gap to be $30.1 billion, which was composed of $28.1 billion of individual income tax and $2 billion of estate taxes. In February 2006, the IRS updated this estimate to $25 billion for individual income tax. The individual estimate was based on data provided by the U.S. Census Bureau. However, there are supplemental data that suggest substantial amounts are not included in the tax gap estimates. For example, the tax gap maps describe the nonfiling estimate as reasonable despite the missing segments of corporate income, employment, and excise taxes. The IRS does not have definite plans to update the estate tax segment[7] or to estimate the corporate, employment, and excise tax nonfiler segments, suggesting that the nonfiler estimate is incomplete and likely inaccurate.

In July 2004, researchers in the Small Business/Self-Employed (SB/SE) Division issued a report on business nonfilers recommending implementation of an enhanced system for creating and selecting inventory. Subsequently, the SB/SE Division Research office developed a prototype that matched $4.6 trillion in transactions to over one-half of the business nonfilers for TY 2002, detecting approximately $1 trillion of apparent taxable income. This fact alone brings the $27 billion individual and estate nonfiling estimate into question and demonstrates the need for more research to better estimate nonfiling for all tax segments.

Underreporting

The tax gap attributed to underreporting is by far the largest identified portion of the tax gap at an estimated $285 billion. Yet, TIGTA concluded that this estimate may not be

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[4] The IRS' goal in its 2007 budget is to reach an 85 percent VCR by 2009.
[5] *Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections,* (TIGTA Reference Number 2006-50-077, dated April 2006..
[6] The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. The portion of the gross tax gap that is not eventually collected is called the net tax gap.
[7] Currently consideration is being given to eliminating or reducing the number of people required to pay estate taxes.

complete since there are at least four areas that suggest substantial amounts are not included in the tax gap map projections.

- *First*, the business income portion of the individual underreporting tax gap estimate is incomplete because it lacks information from another NRP study that the IRS is undertaking on flowthrough returns[8] of Subchapter S corporations.[9] The study, which began in October 2005, will take 2 years to 3 years. Thus, the information from these audits was not available for the February 2006 updated TY 2001 tax gap estimates. Over 2.9 million Subchapter S Corporation returns were filed in TY 2001 with more than 5.3 million shareholders reporting $187.7 billion in net income.

- *Second*, the revised tax gap map lists the underreporting gap at $5 billion for small corporations and $25 billion for large corporations. These amounts are essentially carryovers from the previous estimate, including their weaker certainty status, since no new information was developed. For small corporations, the estimate is based on the 1980 TCMP survey. For large corporate underreporting, the previous estimates were not based on random TCMP audits but on operational audit coverage from the mid-1980s. These projections assume constant VCRs, yet current experience suggests compliance may not be constant. For example, in 2003, an IRS contractor estimated that the yearly tax gap arising from abusive corporate tax shelters alone was between $11.6 billion and $15.1 billion.[10]

- *Third*, the revised map similarly categorized as reasonable a $4 billion figure for estate taxes and provided no estimate for excise taxes, yet the estate tax estimate was not updated during the current NRP. In addition, there are no firm plans for further studies or updates of these components.

- *Fourth*, for the employment tax component, the combined $15 billion Federal Insurance Contributions Act and unemployment tax gap figure was also carried over and will not be further studied. Most of the employment tax component consists of self-employment tax. Yet, similar to the business income portion of the individual income tax gap, this too is incomplete without the flowthrough data.

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[8] These include partnerships and Subchapter S corporations through which individual partners and shareholders, respectively, derive tax information from those entities. The flowthrough study covers only Subchapter S corporations and not partnerships. In 1958, Congress established Subchapter S of the Internal Revenue Code that enables small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders. Subsequently, the Code was revised to allow as many as 100 shareholders. Electing this form of business organization, commonly referred to as an S corporation, exempts the profits from corporate taxation and allows the profits to "pass through" to the shareholders who are then responsible for individual income taxes on the profits.

[9] The study began in October 2005 with audits of TY 2003 returns.

[10] The IRS has not developed a new estimate of this figure.

Payments collected

The IRS' tax gap maps, both before and after the NRP, list $55 billion as recoveries or enforced collections and other late payments.[11] This figure does not represent an actual amount but is an estimate projected from historical information and formulas based on what is known about the amount of collections on accounts over time. However, TIGTA found the actual basis of these formulas to be very limited, as well as dated. According to IRS officials, these formulas were developed "quite some time ago." Thus, these formulas most likely do not take into account changes in the IRS' ability to collect revenue.

To determine the validity of the potential $55 billion in collections, TIGTA requested data from the IRS on actual collections for TY 2001 by year of collection. These collections have two basic components: voluntary payments received by the IRS after the due date and payments received by the IRS as a result of some type of IRS intervention. The IRS, however, does not currently correlate either type of payment to the applicable tax year. Consequently, the IRS has no means of determining whether the $55 billion is ever collected. While the IRS is currently developing a way to associate collections resulting from enforcement actions to the related tax years, no similar data are being developed for voluntary late payments. Unless the latter data are similarly correlated, the IRS will be unable to determine actual collections or an accurate net tax gap.

Methodology

Beyond the concerns about the completeness and accuracy of the current tax gap estimates, TIGTA has additional concerns about the samples and adjustments made to the estimates. Both sampling and adjustments can have a significant effect on the confidence that can be placed in the estimates.

A significant concern about sampling for the NRP studies is whether the sample sizes would affect the usefulness or, perhaps, the accuracy of the data. Performing the studies depends on limited audit resources. IRS research officials described the problem as acute for the current flowthrough study. The most recent TCMP survey of partnerships, for example, involved a sample size that was significantly larger than the present normal, or operational, audit coverage of partnership returns. That sample size was sustainable at the time of the TCMP survey when the operational audit program was much larger, but it is not feasible now. The same was true of the last TCMP survey of Subchapter S corporation returns. The NRP office proposed much smaller sample sizes for its current surveys of flowthroughs, not because the same sample sizes are no longer needed but because the resources necessary to sustain the required number of random audits are not available.

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[11] According to one IRS representative, these collections can take up to 10 years because of appeals and court decisions.

Although IRS Research officials told TIGTA that the sample size was not an issue for the individual income tax study, the size of the calibration sample[12] for the individual study was constrained by fewer resources than what would have been preferred. An IRS consultant's evaluation of the NRP's sample design expressed concern that using the calibration audits to adjust the NRP could introduce considerable error into the adjusted estimates. My staff consulted with one researcher who believed the appropriate size of the original NRP sample was an open question that needs addressing for future work. Furthermore, as a result of software issues and anomalies in the data, only about 37,000 of the original 46,000 cases in the original sample were used in the most recent tax gap estimate.

TIGTA is also concerned about the estimate's use of multipliers. Multipliers are essentially methods used to estimate undetected additional taxable income. Using multipliers complicates the confidence in, and precision of, the estimates.

In summary, much of the information remains dated, the new information is incomplete in several respects, and methodology differences create challenges. Considering this, a somewhat different picture of the tax gap map emerges. My staff concluded that, despite the significant efforts undertaken in conducting the individual taxpayer NRP, the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and the VCR. Although having new information about TY 2001 individual taxpayers is better when compared to the much older TY 1988 information from the last TCMP survey, some important individual compliance information remains unknown. Additionally, although individuals comprise the largest segment of taxpayers and were justifiably studied first, no new information about employment, small corporate, large corporate, and other compliance segments is available. With no firm plans for further studies or updates in many areas of the tax gap, both the underreporting tax gap and the nonfiling gap will indefinitely leave an unfinished picture of the overall tax gap and compliance.

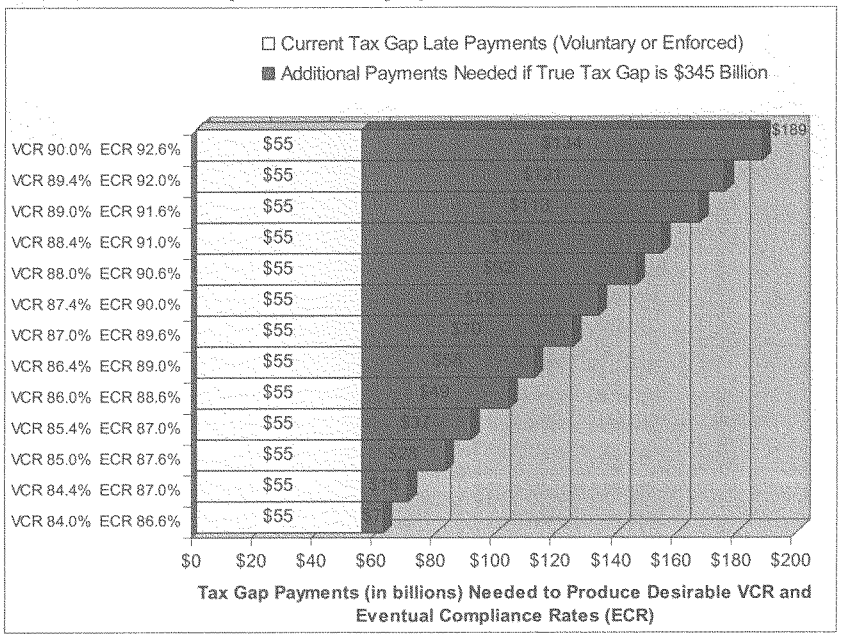
Achieving Targeted Voluntary Compliance Goals

While TIGTA has concerns about the overall reliability of the tax gap projections, the annual amounts collected that reduce the net tax gap, and the VCR, my staff determined that it was instructive to analyze what additional amounts the IRS would have had to collect to reach 90 percent voluntary compliance at different estimated intervals for TY 2001. Figure 3 shows the range for TY 2001 based upon the total tax liability for TY 2001 as estimated in February 2006. The IRS has proposed in the FY 2007 budget that the VCR will be raised from 83.7 percent to 85 percent by 2009. Accordingly, if the total

[12] Without the intensive audits that characterized the TCMP, the NRP may obtain less complete information, possibly resulting in misstatement of tax liabilities. To address this potential bias, the NRP conducted more comprehensive line-by-line audits of a small calibration sample of 1,683 returns to provide a means of evaluating and, if necessary, correcting the full sample for this bias. The IRS Office of Research believes the quality level of the NRP is about the same as that for the TCMP.

tax liability remained constant, the IRS would have to collect, on a voluntary and timely basis, $28 billion more in TY 2009, thus reducing the gross tax gap to $317 billion. To reach 90 percent voluntary compliance by TY 2010,[13] the amount voluntarily and timely collected for TY 2010 would be an additional $134 billion, thus reducing the gross tax gap to $211 billion if the total tax liability remained constant.

Figure 3: Additional Voluntary and Timely Payments Required to Reach Specified VCR Levels[14]



Source: Treasury Inspector General for Tax Administration

[13] This is the amount previously described in this report that was called for by Senator Baucus. See *Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections,* (TIGTA Reference Number 2006-50-077, dated April 2006.

[14] Payment of the $55 billion estimated by the IRS as late or enforced payments does not affect the VCR. However, it does affect the total amount collected by the IRS. Therefore, we developed the Eventual Compliance Rate term that shows the effect of these payments when coupled with additional voluntary and timely payments that do affect the VCR.

Barriers Hampering Compliance Research

Performing a compliance measurement program is expensive and time consuming. The estimated cost for performing the TY 2001 individual taxpayer NRP was approximately $150 million. According to IRS officials, resource constraints are a major factor in NRP studies and affect how often the NRP is updated. Operational priorities must be balanced against research needs. From FY 1995 through FY 2004, the revenue agent workforce declined by nearly 30 percent while the number of returns filed grew by over 9 percent. This shortfall in examiner resources makes conducting large-scale research studies problematic.

The IRS' budget submission to the Department of the Treasury (the Department) for FY 2007 requests funding to support ongoing NRP reporting compliance studies. The IRS Oversight Board[15] supports ongoing dedicated funding for compliance research. Unfortunately, funding for those resources in previous fiscal years did not materialize. Without a resource commitment for continual updating of the studies, the information will continue to be stale and less useful in measuring voluntary compliance.

Learning From Previous Attempts to Reduce the Tax Gap

In June 1993, IRS executives met with Treasury and Office of Management and Budget (OMB) officials to discuss key issues for the FY 1995 budget. The issues facing the Federal Government at that time were similar to the current issues: severe fiscal constraints and the desire for good tax administration. Consequently, both the Department and OMB agreed to work with the IRS on a comprehensive plan to reduce the tax gap.[16] The IRS formed a task group that performed an extensive review of the tax gap.[17] The resulting task force report addressed the major areas of the tax gap and provided recommendations. The report concluded that:

- Enforcement is the most costly option and delivers only limited revenue.
- Methods to increase voluntary compliance are less costly but more burdensome to taxpayers.
- Legislative changes are needed as the primary means to increase compliance levels.
- The TCMP surveys can be used to identify the types of noncompliance but not the causes.
- The IRS needs to reevaluate its media and taxpayer education efforts.

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[15] According to the IRS Oversight Board web site (irsoversightboard.treas.gov), it is an "independent body charged to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction."

[16] IRS Tax Gap Report: Strategies for Closing the Tax Gap, October 1993, page 3.

[17] IRS Tax Gap Report: Strategies for Closing the Tax Gap, October 1993.

- The tax gap needs to be treated as a multibillion dollar market, and efforts need to be made to capture as much of that market as possible.
- The IRS needs to consider making a high-level official responsible for overseeing efforts to close all components of the tax gap.
- The IRS Strategic Plan needs to be modified to more closely align with the tax gap components.

TIGTA was unable to determine if the report's recommendations were implemented.

Opportunities for Closing the Tax Gap

Although better data will help the IRS identify noncompliant segments of the population, broader strategies and better research are also needed to determine what actions are most effective in addressing noncompliance. The IRS must continue to seek accurate measures of the various components of the tax gap and the effectiveness of actions taken to reduce it. This information is critical to the IRS for strategic direction, budgeting and staff allocation. The Department also needs these measures for tax policy purposes. Additionally, Congress needs this information to develop legislation that improves the effectiveness of the tax system.

Recommendations on how to address closing the tax gap have been circulating for many years. Some of those recommendations, made over 15 years ago, are still relevant today. I would like to focus on the following opportunities that TIGTA, other oversight groups, and interested stakeholders have identified to address the tax gap:

- Reduce the Complexity of the Tax Code.
- Gather Better Compliance Data.
- Refine Compliance Strategies.
  - High-Income Taxpayers.
  - Abusive Tax Shelters.
  - Information Reporting on Sales of Investments.
  - Withholding on Non-employee Compensation.
  - Document Matching.
  - Late Filed Returns.
  - Coordinated National Nonfiler Strategy.
- Increase Resources in the IRS Enforcement Functions.

Reduce the Complexity of the Tax Code

The topic of tax law complexity generally evokes calls for tax law simplification. Government, academic and technical studies suggest a strong correlation between tax law complexity and tax law compliance. The greatest case for the correlation is that complexity allows legal tax avoidance, which at times can evolve into illegal tax evasion. The argument continues that because of tax law complexity, it is often difficult to ascertain whether a taxpayer has intentionally evaded taxes, or whether there was an

honest misunderstanding. Therefore, the IRS use of punitive penalties must be tempered to ensure taxpayers are not penalized for honest misunderstandings.

In 2001, the Joint Committee on Taxation conducted a study on the complexity of the tax law. The Committee found that, at that time, the tax code consisted of nearly 1.4 million words. There were 693 sections of the code applicable to individuals, 1,501 sections applicable to businesses, and 445 sections applicable to tax exempt organizations, employee plans, and governments. At that time, a taxpayer filing an individual income tax return (Form 1040) could be confronted with a 79 line return, 144 pages of instructions, 11 schedules totaling 443 lines (including instructions), 19 separate worksheets embedded in the instructions, and the possibility of having to file numerous other forms.[18]

The President's Advisory Panel on Federal Tax Reform also cited tax code complexity as a significant problem.[19] Among others, sources of complexity include duplicative and overlapping provisions, phase-outs, and expiring provisions. In addition, the panel cited the instability of the tax code as another source of complexity. Since 1986, there have been more than 14,400 changes to the code. This complexity is costing the U.S. economy $140 billion each year, with taxpayers spending over 3.5 billion hours preparing tax returns, and more than 60 percent of them now rely on a tax practitioner to prepare their tax returns.

One of the major effects attributed to tax law complexity is that it causes lower voluntary compliance. According to the American Institute of Certified Public Accountants, tax law complexity:

- Increases perceptions that the tax system is unfair.
- Increases costs for tax administration and tax compliance.
- Decreases the quality of tax administration and tax assistance.
- Increases the number of inefficient economic decisions.

Although it is believed that tax law simplification would increase voluntary compliance, there are significant factors that suggest simplification will be difficult to achieve throughout the Internal Revenue Code. The Joint Committee on Taxation identified various sources of complexity, and no single source was primarily responsible. The sources identified were:

- A lack of clarity and readability of the law.
- The use of the Federal tax system to advance social and economic policies.
- Increased complexity in the economy.

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[18] Staff of the Joint Committee on Taxation, 107th Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (Comm. Print 2001).

[19] The President's Advisory Panel on Federal Tax Reform, Complexity and Instability Staff Presentation (July 20, 2005).

- The interaction of Federal tax laws with State laws, other Federal laws and standards (such as Federal securities laws, Federal labor laws and generally accepted accounting principles), the laws of foreign countries, and tax treaties. [20]

The lack of clarity and readability of the law results from:

- Statutory language that is, in some cases, overly technical and, in other cases, overly vague.
- Too much or too little guidance with respect to certain issues.
- The use of temporary provisions.
- Frequent changes in the law.
- Broad grants of regulatory authority.
- Judicial interpretation of statutory and regulatory language.
- The effects of the congressional budget process.

A major cause of tax law complexity is tax expenditures. The Congressional Budget and Impoundment Control Act of 1974 defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[21] While there is disagreement over whether the tax expenditure concept accurately measures "tax subsidies,"[22] the methods used to target provisions to specific taxpayer groups does cause tax law complexity.

Experts in tax policy maintain that any tax system will have complexity. Therefore, even though many people believe that tax simplification could provide the impetus for increasing voluntary compliance, a simple tax system could be a very difficult goal to achieve given the complexities of our society and multiple uses of the Internal Revenue Code. Thus, closing the tax gap through tax simplification and eliminating tax expenditures could prove to be challenging. But, to the extent that the tax law can be simplified, most experts believe that voluntary compliance would improve.

Another effective method to increase voluntary compliance might be through greater transparency of transactions. A study by senior IRS researcher Kim M. Bloomquist suggests that beyond the tax law complexity/tax law compliance correlation there may be "trends in the environment that account for the rising tax noncompliance."[23] According to the study, the presumed rise in tax noncompliance "may be due, at least in part, to a shift in taxpayer income away from more visible to less visible sources." According to the study, income that is not subject to third-party reporting is highest among taxpayers with the highest incomes. For the top 5 percent of taxpayers, unmatchable income as a percentage of Adjusted Gross Income increased by over 98 percent between 1980 and 2000.

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[20] Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(b) of the Internal Revenue Code of 1986.
[21] Congressional Budget and Impoundment Control Act of 1974 (PL 93-344), sec. 3(3).
[22] Tax Expenditures: A Review and Analysis Joint Economic Committee. August 1999. page 9.
[23] Trends as Changes in Variance: The Case of Tax Noncompliance, June 2003.

The IRS has shown that there is a high correlation between tax compliance and third-party information reporting. The difference in compliance rates between individual wage-earning taxpayers and those operating businesses is striking. The IRS has estimated that individuals whose wages are subject to withholding report 99 percent of their wages for tax purposes.[24] In contrast, self-employed individuals who formally operate non-farm businesses[25] are estimated to report only about 68 percent of their income for tax purposes. Even more alarming, self-employed individuals operating businesses on a cash basis[26] report just 19 percent of their income to the IRS.

TIGTA believes that a combination of efforts will be required to increase voluntary compliance and reduce the tax gap. Tax simplification and increased transparency through third party reporting are significant contributing factors toward achieving these goals.

Gather Better Compliance Data

The IRS' National Research Program (NRP) is designed to measure taxpayers' voluntary compliance, better approximate the tax gap, and develop updated formulas to select noncompliant returns for examination. The first phase of this program addressed reporting compliance for individual taxpayers, and data from this phase were used to produce the updated estimates of this portion of the tax gap. These initial findings should enable the IRS to develop and implement strategies to address areas of noncompliance among individual taxpayers.

The next phase of the NRP, which has begun, focuses on Subchapter S corporations (Forms 1120S). These initiatives allow the IRS to update return-selection models for more effective return selection for its compliance efforts. In 2005, TIGTA reported that the return-selection formulas, developed in the 1980s, only accounted for the selection of 22 percent of the corporate returns selected for examination in FY 2004.[27] Updated selection models should contribute to more effective use of the IRS' compliance resources.

In April 2006, TIGTA recommended that the IRS Commissioner continue to conduct NRPs on a regular cycle for the major segments of the tax gap. TIGTA also

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[24] *See* General Accounting Office, *supra* note 7; Internal Revenue Service, Pub. 1415, Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992, (Rev. 1996).

[25] Formal, non-farm businesses are considered to be those that are typically not operated on a cash basis and that pay expenses such as taxes, rent, or insurance.

[26] These individuals provide products or services through informal arrangements that typically involve cash transactions or "off-the-books" accounting practices. This group includes child care providers, street vendors, and moonlighting professionals.

[27] *The Small Business/Self-Employed Division Is Beginning to Address Challenges That Affect Corporate Return Examination Coverage* (TIGTA Reference Number 2005-30-130, dated August 2005).

recommended that the IRS augment the direct measurement approach, and devise indirect measurement methods to assist in quantifying the tax gap. The IRS agreed with these recommendations, subject to available resources. In addition, TIGTA recommended that the IRS Commissioner consider establishing a tax gap advisory panel that includes tax and economic experts to help identify ways to better measure voluntary compliance. The IRS agreed to look into establishing such an advisory group with the intent of using it to validate and improve estimation methods.

Refine Existing and Develop New Compliance Strategies

The IRS conducts various compliance activities in an effort to reduce the tax gap. However, the IRS needs to develop a comprehensive strategy to reduce the tax gap. Almost 27 years ago, the GAO testified that "...it is clear that the Service [IRS] needs a comprehensive compliance strategy. To develop this, the IRS needs to determine the extent to which it is presently detecting unreported income from the various pockets of noncompliance. It then needs to consider reallocating its resources based on that determination and assess the need for additional resources to close the tax gap for each source of unreported income."[28]

High-Income Taxpayers

Since FY 2000, the IRS' Small Business/Self-Employed (SB/SE) Division has increased examinations of potentially noncompliant high-income taxpayers. In FY 2005, examinations of high-income taxpayers were at their highest level since FY 1996. As previously noted, the IRS considers high-income taxpayers to be those who file a U.S. Individual Income Tax Return (Form 1040) with Total Positive Income (TPI)[29] of $100,000 or more and those business taxpayers who file a Form 1040 with Total Gross Receipts of $100,000 or more on an Profit or Loss From Business (Schedule C) or on an attached Profit or Loss From Farming (Schedule F).

TIGTA recently reported the results of its review of the IRS' increased examination coverage rate[30] of high-income taxpayers.[31] The increased coverage has been due largely to an increase in correspondence examinations,[32] which limit the tax issues the IRS can

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[28] Statement of Richard L. Fogel, Associate Director, General Government Division Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, September 6, 1979.

[29] Generally, the TPI is calculated by using only positive income values from specific income fields on the tax return and treats losses as a zero. For example, a tax return filed with wages of $90,000, interest of $12,000, and a $25,000 loss from an interest in a partnership would have a TPI totaling $102,000 and be considered a high-income tax return by the IRS.

[30] The examination coverage rate is calculated by dividing the number of examined returns in a category by the number of returns in the same category filed in the previous year.

[31] *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* (TIGTA Reference Number 2006-30-105, dated July 24, 2006).

[32] Correspondence examinations are important compliance activities focusing on errors and examination issues that typically can be corrected by mail. They are conducted by sending the taxpayer a letter requesting verification of certain items on the tax return. These examinations

address in comparison with face-to-face examinations. In addition, the compliance effect may be limited because over one-half of all high-income taxpayer examination assessments are not collected timely.

The examination coverage rate of high-income taxpayers increased from 0.86 percent in FY 2002 to 1.53 percent in FY 2005. Included in this statistic is an increase in the examination coverage rate of high-income tax returns, Forms 1040 with a Schedule C. This examination coverage rate increased from 1.45 percent in FY 2002 to 3.52 percent in FY 2005. However, the increase in examination coverage is due largely to an increase in correspondence, rather than face-to-face, examinations. While face-to-face examinations increased by 25 percent from FY 2002 through FY 2005, correspondence examinations increased by 170 percent over the same period.

As a result, the percentage of all high-income taxpayer examinations completed through the Correspondence Examination Program grew from 49 percent in FY 2002 to 67 percent in FY 2005. The increase in correspondence examinations for high-income taxpayers who filed a Schedule C was even larger. Examinations closed by correspondence comprised about 30 percent of all high-income taxpayer Schedule C examinations from FYs 2002 through 2004. In FY 2005, approximately 54 percent of all high-income taxpayer Schedule C examinations were conducted by correspondence.

High-income households typically have a large percentage of their income that is not subject to third-party information reporting and withholding. The absence of third-party information reporting and withholding is associated with a relatively higher rate of underreporting of income among business taxpayers. It is difficult to determine through correspondence examination techniques whether these taxpayers have reported all of their income.

In FY 2004, the IRS assessed more than $2.1 billion in additional taxes on high-income taxpayers through its Examination program. This figure includes assessments of $1.4 billion (66 percent) on taxpayers who did not respond to the IRS during correspondence examinations. Based on a statistical sample of cases,[33] TIGTA estimates that approximately $1.2 billion[34] (86 percent) of the $1.4 billion has been either abated[35] or not collected after an average of 608 days — nearly 2 years after the assessment was made. Our conclusion is that the Examination and Collection programs for high-income taxpayers may not be positively affecting compliance, given the substantial assessments that have been abated or not collected.

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are much more limited in scope than office and field examinations in which examiners meet face to face with taxpayers to verify information.

[33] TIGTA selected the sampled cases from those completed in FY 2004 to provide sufficient time for collection activities.

[34] Margin of error ± 5.05 percent.

[35] Abatement occurs when the IRS reduces an assessment, in this case from reversing examination findings that had uncovered apparent misreported income, deductions, credits, exemptions, or other tax issues.

TIGTA recommended that the IRS complete its plan to maximize the compliance effect of high-income taxpayer examinations. TIGTA also recommended that the plan should include the mixture of examination techniques, issues examined, and collection procedures. The IRS agreed with our recommendations.

Abusive Tax Shelters

The taxpaying public has long sought ways to minimize tax liabilities by sheltering income and gains from taxes through investments and other financial-related transactions. Some tax shelters, however, have received widespread publicity because they purportedly abuse the tax law, represent a significant loss of tax revenue, and undermine the public's confidence in the tax system. The Son of Boss[36] is one such abusive tax shelter. For this abusive tax shelter, the IRS estimated understated tax liabilities in excess of $6 billion.

The IRS considers identifying and combating abusive tax shelters extremely important, and this priority was reflected in the emphasis given to resolving the Son of Boss abusive tax shelter and ensuring a successful settlement initiative. The IRS publicly announced the settlement initiative in May 2004, and IRS management at all levels closely coordinated the initiative's implementation to ensure its success. A centralized office was established to receive investor application packages, where they were screened for suitability and forwarded to Examination function groups located in offices throughout the country. Once the packages were received in the groups, examiners were assigned to validate the accuracy of the information on an investor application, determine the amount of out-of-pocket expenses[37] to allow, compute the amount of additional taxes owed, execute a closing agreement, and make arrangements with the investor to receive payment for the taxes owed. Throughout the initiative, interim reports were prepared as a control mechanism to monitor progress and track the cases for both investors participating in the settlement and nonparticipating investors. As of March 16, 2005, interim reports showed 1,039 participating investors had settled their cases by paying or agreeing to pay more than $2.7 billion in taxes, interest, and penalties.

TIGTA reviewed the IRS' efforts and made two observations that the IRS may find useful in its efforts to curtail abusive tax shelters.[38] First, experience demonstrated that the general 3-year statutory assessment period was insufficient for tax administrators to

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[36] The Son of Boss (Bond and Option Sales Strategies) tax shelter was a highly sophisticated, technically complex, no-risk scheme designed to generate tax losses without corresponding economic risks. It was promoted by some prominent firms in the financial services industry to investors seeking to shelter large gains from the sale of a business or capital asset. The scheme used flowthrough entities, such as partnerships, and various financial products to add steps and complexity to transactions that had little or no relationship to the investor's business or the asset sale creating the sheltered gain. Additionally, the losses generated from the transactions were often reported among other "legitimate" items in several parts of the income tax return. Some losses, for example, were reported as a reduction to gross sales, cost of goods sold, or capital gains.

[37] Out-of-pocket expenses are transaction fees that were typically paid by investors to promoters.

[38] *The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters* (TIGTA Reference Number 2006-30-065, dated March 2006).

examine and assess all identified participants in the Son of Boss abusive tax shelter. Although it is difficult to precisely estimate the fiscal impact of abusive tax shelters, State officials in California estimated losing between $2.4 billion and $4 billion over 4 years to various abusive tax shelters. They changed State income tax laws to give California State tax administrators up to 8 years to assess additional taxes related to abusive tax shelters. Steps were also taken in New York and Illinois to double statutory assessment periods from 3 years to 6 years.

At the Federal level where the loss from abusive tax shelters has been estimated at $85 billion,[39] a provision in the American Jobs Creation Act of 2004 (AJCA)[40] provided the IRS with up to 1 additional year to assess taxes related to a "listed" transaction[41] if it is not properly disclosed on the return. Despite the positive, open-ended feature in the AJCA provision, an analysis of 1,958 income tax return examinations of investors in the Son of Boss abusive tax shelter found that the limited 1-year extension does not accurately reflect the time needed to complete the examination and assessment process involved in resolving complex, technical abusive tax shelters. As a result, the 1-year extension in the AJCA could prove overly restrictive to realizing intended benefits from the extended assessment period.

TIGTA also observed that another possible step the IRS could take is to plan for and conduct an assessment that captures the overall successes achieved and lessons learned in resolving the Son of Boss abusive tax shelter. Such an assessment could provide an important tool for managers to use if they are faced with a challenge of this magnitude in the future. In addition, it would be in line with both the Government Performance and Results Act of 1993[42] and IRS guidance for analyzing program performance and identifying improvement options.

TIGTA recommended that the IRS determine whether the AJCA provision extending the statutory assessment period is adequate to protect tax revenues and deter participation in abusive tax shelters. TIGTA also recommended that the IRS evaluate and document its overall performance in resolving the Son of Boss abusive tax shelter. The IRS agreed with TIGTA's recommendation to evaluate its overall performance resolving the Son of Boss abusive tax shelter. The IRS did not agree to take action to determine whether the AJCA provision extending the statutory assessment period is adequate for protecting tax revenues and deterring participation in abusive tax shelters. According to the IRS, more experience is needed before it can determine whether the 1-year provision provided by the AJCA is adequate. The IRS may be missing an opportunity to further strengthen its ability to combat abusive tax shelters by not taking action on this recommendation.

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[39] *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters* (GAO-04-104T, dated October 2003).
[40] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[41] A listed transaction is the same as or substantially similar to one of the types of transactions the IRS determined to be a tax avoidance transaction and identified by notice, regulation, or other form of IRS published guidance.
[42] Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

Information Reporting on Sales of Investments

According to professors Joseph M. Dodge and Jay A. Soled,[43] "An unpublicized problem of crisis proportions is plaguing the administration of the Internal Revenue Code, and it is costing the nation billions of dollars annually. The problem is neither hyper-technical nor hard to discern: On the sale of investments, taxpayers inflate their tax basis and do so with impunity, which results in the underreporting of gains and the overstatement of losses."[44] In June 2006, the GAO reported that expanding the information brokers report on securities sales to include adjusted cost basis has the potential to improve taxpayers' compliance and help IRS find noncompliant taxpayers.[45]

The GAO estimates that 38 percent of individual taxpayers with securities transactions misreported their capital gains or losses in TY 2001. According to the GAO, roughly two-thirds of individual taxpayers underreported and roughly one-third overreported. About half of the taxpayers who misreported failed to accurately report the securities' cost or basis.

The lack of information on the basis of investments limits the effectiveness of IRS compliance efforts. Taxpayers report their income much more accurately when there is third-party reporting to the IRS. For the IRS, basis reporting would provide information to verify investment gains or losses, which would allow it to better focus enforcement resources on noncompliant taxpayers. Although basis reporting presents some administrative challenges, the GAO concluded that many of the challenges to implementing basis reporting could be mitigated.

Institute Withholding on Non-employee Compensation

Each year, over 40 percent ($130 billion) of the total tax gap is attributable to underreporting among individuals with business income. More than 20 years ago, the GAO recommended that Congress consider requiring withholding and improving information returns reporting for independent contractors.[46] Two years ago, TIGTA recommended that the IRS initiate a proposal for a legislative change to mandate withholding on non-employee compensation payments, such as those provided to

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[43] Joseph M. Dodge is the Stearns Weaver Miller Weissler Alhadeff & Sitterson Professor at Florida State University College of Law. Jay A. Soled is a professor at Rutgers University.
[44] Joseph M. Dodge and Jay A. Soled, "Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question," Tax Notes, January 24, 2005.
[45] *Capital Gains Tax: Requiring Brokers to Report Securities Cost Basis Woud Improve Compliance if Related Challenges Are Addressed* (GAO-06-603, dated June 2006).
[46] Statement of Richard L. Fogel, Associate Director, General Government Division before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, September 6, 1979.

independent contractors.[47] Implementing such a provision could reduce the tax gap by billions of dollars.

The Joint Committee on Taxation made a proposal to implement withholding on payments from government entities.[48] The proposal recommended withholding 3 percent of payments to businesses and individuals (other than employees) providing goods and services to government entities. This proposal may be a good first step as it would provide an opportunity to test the feasibility and burden associated with such withholding.

In addition to implementing withholding on non-employee compensation, other actions should be taken to improve compliance among independent contractors. For example, improvement is needed to address inaccurate reporting of Taxpayer Identification Numbers (TINs) for independent contractors. For TY 1995 through TY 1998, the IRS received about 9.6 million statements for Recipients of Miscellaneous Income (Forms 1099-MISC), reporting approximately $204 billion in non-employee compensation that either did not contain a TIN or had a TIN that did not match IRS records.

Legislation might help improve TIN accuracy by permitting disclosure to any person required to provide a TIN to the IRS whether such information matches records maintained by the IRS.[49] This would allow a payor to verify the TIN furnished by a payee prior to filing information returns for reportable payments. Additionally, withholding could be mandated for independent contractors who fail to furnish a TIN. Implementing mandated withholding for this segment of independent contractors would result in an estimated $2.2 billion in increased revenue to the IRS each year.

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[47] *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* (TIGTA Reference Number 2004-30-040, dated February 2004); *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* (TIGTA Reference Number. 2001-30-132, dated August 2001).

[48] Staff of the Joint Committee on Taxation, 109th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures (Comm. Print 2005).

[49] S. 1321, Telephone Excise Tax Repeal Act Of 2005.

Document Matching

TIGTA has also identified improvements that should be made to improve compliance in business tax filing. [50] The GAO reported that more than 60 percent of U.S.-controlled corporations and more than 70 percent of foreign-controlled corporations did not report tax liabilities from 1996 through 2000. [51] Although individual wage earners who receive a Wage and Tax Statement (Form W-2) have their wages verified through a matching program, a similar comprehensive matching program for business documents received by the IRS does not exist. TIGTA has recommended that the IRS evaluate all types of business documents it receives to determine whether this information can be used to improve business compliance. In its response to our recommendations, the IRS wrote that it could not implement this recommendation at that time. However, the IRS also shared its belief that ongoing efforts would provide the results that our recommendation hoped to achieve and asked for the opportunity to continue its efforts.

An IRS study, based on TIGTA recommendations, found that in FY 2000, business information documents[52] reported $697 billion of potential taxable income.[53] Furthermore, business information documents identified 1.2 million unresolved IRS business nonfiler tax modules. An IRS tax module contains records of tax liability and accounting information pertaining to the tax for one tax period. TIGTA has also reported on issues related to the increasing global economy. Investments made abroad by U.S. residents have grown in recent years, nearly tripling from $2.6 trillion in 1999 to $7.2 trillion in 2003. To address the tax compliance challenges presented by foreign investments, TIGTA recommended that the IRS make better use of the foreign-source income information documents received from tax treaty countries. TIGTA also recommended that, prior to issuing refunds to foreign partners, the IRS implement an automated crosscheck of withholding claims against available credits for partnerships with foreign partners.[54]

Implementing a comprehensive matching program to identify noncompliance among businesses would be difficult and could require some legislative changes, but it could identify significant pockets of noncompliance among business taxpayers.

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[50] *The IRS Should Evaluate the Feasibility of Using Available Documents to Verify Information Reported on Business Tax Returns* (TIGTA Reference Number 2002-30-185, dated September 2002).

[51] General Accounting Office, Pub. No. GAO-04-358, TAX ADMINISTRATION: Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000 (2004).

[52] The IRS receives over 30 different types of business information documents yearly. Most of these forms have a legal requirement for issuance to corporations. The three information documents most often issued to business nonfilers are Forms 1099-B (Proceeds from Broker and Barter Exchange Transactions), 1099-MISC (Miscellaneous Income), and 4789 (Currency Transaction Reports).

[53] Internal Revenue Service, Report of BMF IRP Nonfilers for TY 2000 (Corporations, Partnerships, and Trusts), Research Project 02.08.003.03, SB/SE Research (July 2004).

[54] *Stronger Actions Are Needed to Ensure Partnerships Withhold and Pay Millions of Dollars in Taxes on Certain Income of Foreign Partners* (TIGTA Reference Number 2001-30-084, dated June 2001); *Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data* (TIGTA Reference Number 2005-30-101, dated July 2005).

Late Filed Returns

Taxpayer payment compliance means that the amounts owed are paid on time. However, for decades, the IRS has allowed taxpayers with extended return filing due dates to send in late payments and pay only interest and small failure-to-pay penalties. Obtaining an extension of time to file a tax return does not extend the due date for tax payments, and failure-to-pay penalties are typically assessed when payments are made late, even if the taxpayer has received an extension.

In 1993, IRS management eliminated the requirement to pay all taxes by the payment due date in order to qualify for an extension of time to file. Once an extension has been granted, the taxpayer is exempt from a 5 percent per month delinquency penalty[55] for the period of the extension. TIGTA evaluated the impact of these rules on individual and corporate taxpayers and found that 88 percent of untimely tax payments for returns filed after April 15th were attributable to extended-due-date taxpayers.[56] Corporations are required to pay estimates of their unpaid taxes in order to be granted extensions. However, TIGTA found corporate estimates to be highly flawed; in calendar year (CY) 1999 alone, approximately 168,000 corporations received an extension, yet failed to pay $1.8 billion in taxes when they were due.

TIGTA projected that the tax gap from extension-related individual income tax underpayments would amount to approximately $46.3 billion in CY 2008, of which approximately $29.8 billion would not be paid until after the end of FY 2008. Due to the more complex nature of corporate taxes, similar figures were not available for corporations, although TIGTA estimated that by TY 2008, approximately $768 million in additional corporate taxes would be timely paid if TIGTA's recommendations were adopted. The IRS agreed to study TIGTA's recommendations.

Coordinated Nonfiler Strategy

According to the IRS' February 2006 tax gap map, individual and estate tax non-filers accounted for about 8 percent of the total tax gap[57] for TY 2001. Corporate income, estate and excise tax non-filing estimates were not available. The IRS study, together with previous IRS studies, indicates the tax gap for individual non-filers almost tripled from $9.8 billion in TY 1985 to about $27 billion[58] in TY 2001.

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[55] The Delinquency Penalty is also known as the Failure-to-File Penalty, although it only applies to taxpayers who both file late and fail to pay all taxes by the tax payment deadline.

[56] *The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers* (TIGTA Reference Number 2003-30-162, dated August 2003); *Changes to the Regulations for Granting Extensions of Time to File Corporate Returns Are Needed to Alleviate Significant Problems With Administering the Tax Laws* (TIGTA Reference Number 2004-30-106, dated June 2004).

[57] The non-filer tax gap is the dollar amount of taxes not paid timely on delinquent and non-filed returns.

[58] The estimated tax gap of $27 billion in TY 2001 was comprised of $25 billion for individual income tax non-filing and $2 billion associated with estate and gift tax. The estimate is developed

In the past, the IRS had several strategies for reducing the tax gap attributable to individual non-filers. The most recent National Non-filer Strategy, which was developed for FY 2001 through FY 2003, was made obsolete in July 2002 when the IRS was reorganized. Since then, each IRS business division has been responsible for tracking and monitoring completion of its own action items. Consequently, there has been no formal system in place for coordinating and tracking all actions across all IRS divisions.

In November 2005, TIGTA reported that as increasing voluntary compliance remains a Service-wide effort, the individual business divisions within the IRS have taken steps to improve efficiency in working non-filer cases.[59] The actions taken by business divisions included:

- Consolidation of the Automated Substitute for Return Program[60] into one campus.[61]
- Computer programming changes to enhance automated processing of returns created by the IRS for non-filing businesses, as authorized under Section 6020(b) of the Internal Revenue Code.[62]
- Refinement of the processes for selection and modeling of non-filer cases each year through risk-based compliance approaches. The intention is to identify and select the most productive non-filer work and to apply appropriate compliance treatments to high-priority cases.
- Increased outreach efforts by the SB/SE Division through its Taxpayer Education and Communication function.
- An increase in the number of cases recommended for prosecution by the Criminal Investigation Division from 269 in FY 2001 to 317 in FY 2004 (an increase of 17.8 percent).

However, these were not coordinated activities that were planned and controlled within the framework of a comprehensive strategy. Since FY 2001, each business division has independently directed its own non-filer activities. The IRS did not have a

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from other tax gap data sources and is not derived from direct data sources. So, the growth in the dollar amounts in the estimate track the increases in other tax gap estimates.

[59] *The Internal Revenue Service Needs a Coordinated National Strategy to Better Address an Estimated $30 Billion Tax Gap Due to Non-filers* (TIGTA Reference Number 2006-30-006, dated November 2005).

[60] The Automated Substitute for Return Program focuses on high-income taxpayers who have not filed individual income tax returns but appear to owe significant income tax liabilities based on available Information Reporting Program information.

[61] The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

[62] Internal Revenue Code Section 6020(b) (2005) provides the IRS with the authority to prepare and process certain returns for a non-filing business taxpayer if the taxpayer appears to be liable for the return, the person required to file the return does not file it, and attempts to secure the return have failed.

comprehensive, national non-filer strategy or an executive charged with overseeing each business division's non-filer efforts. TIGTA concluded that the IRS needed better coordination among its business divisions to ensure resources are being effectively used to bring non-filers into the tax system and ensure future compliance. The IRS also needed an organization-wide tracking system to monitor the progress of each business division's actions.

In addition to better coordination and an organization-wide tracking system, the IRS also needed measurable program goals. TIGTA suggested three measurable goals that could be established:

- The number of returns secured from non-filers.
- Total payments received.
- The recidivism rate.

Without such measurable program goals, the IRS is unable to determine whether efforts to improve program efficiency and effectiveness are achieving desired results. The IRS agreed with all of TIGTA's recommendations. For FY 2006, the IRS developed its first comprehensive non-filer work plan.

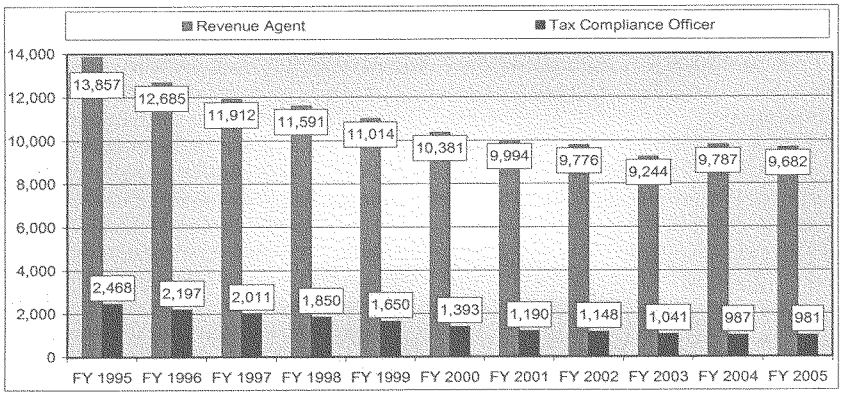
Increase Resources in the IRS Enforcement Functions

In September 1979, the GAO testified before Congress that "The staggering amount of income, at least $135 billion, on which taxes are not paid is shocking."[63] The GAO's testimony focused on the actions the Government should take. The recommended actions included ensuring that the level of the IRS' audit activity did not decline. Unfortunately, while there have been periods of increases in compliance staffing, over the years, the IRS has also experienced declines.

The combined Collection and Examination functions enforcement personnel[64] declined from approximately 22,200 at the beginning of FY 1996 to 14,500 at the end of FY 2005, a 35 percent decrease. While the President's FY 2007 proposed budget for tax law enforcement is a slight increase over the FY 2006 budget, the additional funding may not be sufficient to increase enforcement activity above the level provided in the FY 2006 budget. Even though the IRS has started to reverse many of the downward trends in compliance activities, the Collection and Examination functions' enforcement staffing level is not much higher than the 10-year low experienced in FY 2003.

[63] Statement of Richard L. Fogel, Associate Director, General Government Division before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, September 6, 1979.
[64] Collection and Examination function staff located in field offices, excluding management and overhead staff.

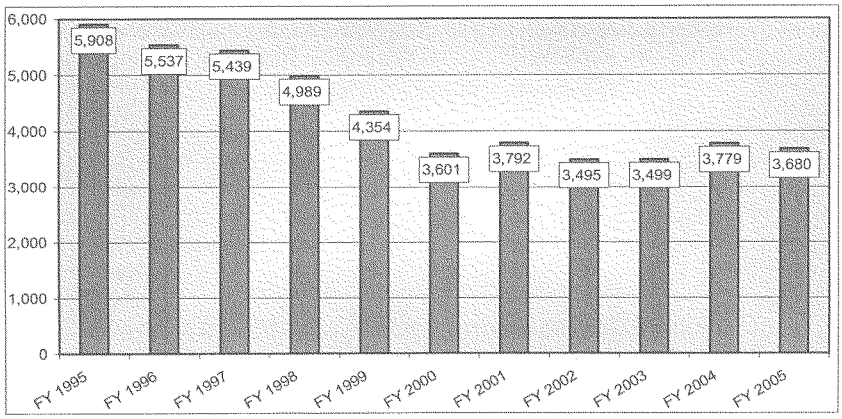
Figure 4: Examination Staffing



Source: TIGTA analysis of IRS' Audit Information Management System Table 37

The numbers in the preceding chart represent the number of Examination function staff conducting examinations of tax returns, excluding management and overhead staff. During FY 2005, revenue agent and tax compliance officer (formerly referred to as tax auditor) staffing decreased, and the combined total is now nearly 35 percent lower than it was at the beginning of FY 1996.

Figure 5: Collection Function Staffing



Source: IRS Collection Reports

The numbers in the preceding chart represent the Collection Field function staffing at the end of each FY 1995 through 2005. The number of revenue officers working assigned

delinquent cases, excluding management and overhead staff, decreased slightly during FY 2005 and is nearly 38 percent fewer than at the start of FY 1996.

One effect of the lack of resources in the Collection function is that the Queue, [65] has increased significantly since FY 1996. In FY 1996, there were over 317,000 balance-due accounts worth $2.96 billion in the Queue. In FY 2004, these figures had increased to over 623,000 balance-due accounts worth $21 billion. Additionally, the number of unfiled tax return accounts in the Queue increased from over 326,000 in FY 1996 to more than 838,000 in FY 2004.

The number of balance-due accounts "shelved," or removed from the Queue altogether because of lower priority, has also increased significantly. In FY 1996, less than 8,000 of these balance due accounts were shelved, but in FY 2004, more than 1 million of these accounts were removed from inventory. From FY 2001 to FY 2004, approximately 5.4 million accounts with balance-due amounts totaling more than $22.9 billion were removed from Collection function inventory and shelved. Additionally, in FY 2004 alone, more than 2 million accounts with unfiled returns were shelved.

If increased funds for enforcement are provided to the IRS in upcoming budgets, the resource issues in the enforcement functions will be addressed to some degree. In addition, use of Private Collection Agencies should allow the IRS to collect more outstanding taxes. The IRS will have to be vigilant in overseeing these contractors to ensure that abuses do not occur. However, past experiences with lockbox thefts and insufficient contractor oversight provide valuable lessons toward reducing the likelihood of similar issues occurring when contracting out collection of tax debt.[66]

Overseeing the IRS' private debt-collection initiative is a top priority for TIGTA. TIGTA has coordinated with the IRS during the initial phases of implementation of this initiative by addressing security concerns with the contracts and protection of taxpayer rights and privacy, and by developing integrity and fraud awareness training for the contract employees. TIGTA has also developed a three-phase audit strategy to monitor this initiative and provide independent oversight.

There are many areas in which increased enforcement and/or legislative remedies could address noncompliance. For example, a TIGTA audit found that a significant number of single shareholder owners of Subchapter S corporations avoided paying themselves salaries to avoid paying employment taxes.[67] We estimated this would cost the Treasury approximately $60 billion in employment taxes over 5 years. Under current law, the IRS

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[65] An automated holding file for unassigned inventory of lower priority delinquent cases that the Collection function does not have enough resources to immediately assign for contact.

[66] *Federal Requirements Need Strengthening at Lockbox Banks to Better Protect Taxpayer Payments and Safeguard Taxpayer Information* (TIGTA Reference Number 2002-30-055, dated February 2002); *Insufficient Contractor Oversight Put Data and Equipment at Risk*, (TIGTA Reference Number 2004-20-063, dated March 2004).

[67] *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations* (TIGTA Reference Number 2005-30-080, dated May 2005).

must perform an examination of these taxpayers to determine reasonable compensation. To accomplish this on any scale would require significant compliance resources.

Additional resources might also help the IRS address the growth in fraudulent returns filed by incarcerated individuals. On June 29, 2005, I testified before the House Committee on Ways and Means, Subcommittee on Oversight about this growing problem.[68] Although prisoner tax returns account for only 0.43 percent of all refund returns, they account for more than 15 percent of the fraudulent returns identified by the IRS. Refund fraud committed by prisoners is growing at an alarming rate. The number of fraudulent returns filed by prisoners and identified by the IRS' Criminal Investigation function grew from 4,300 in processing year 2002 to more than 18,000 in processing year 2004 (a 318 percent increase).[69] During that same period, all fraudulent returns identified grew by just 45 percent.

The IRS' Fraud Detection Centers screen tax returns based on criteria that identify potentially fraudulent filings. The number of returns screened is based on these criteria and the available resources. During processing year 2004, Fraud Detection Centers screened about 36,000 of the approximately 455,000 refund returns identified as filed by prisoners. Resources were not available to screen the remaining 419,000 tax returns. Those returns claimed approximately $640 million in refunds and approximately $318 million of Earned Income Tax Credit (EITC). For those unscreened returns, over 18,000 prisoners incarcerated during all of CY 2003 filed returns with a filing status as "Single" or "Head of Household" and claimed more than $19 million in EITC. Since prisoners were incarcerated for the entire year, they would have had neither eligible earned income to qualify for the EITC nor a qualified child who lived with them for more than six months.

Although increasing enforcement is important in addressing the tax gap, the IRS must exercise great care not to emphasize enforcement at the expense of taxpayer rights and customer service. I believe that steps to reduce the current level of customer service should be taken only with the utmost thought and consideration of their impact, and only with all the necessary data to support these actions. Customer service goals must be met and even improved upon, or people will lose confidence in the IRS' ability to meet part of its mission of providing America's taxpayers quality service by helping them understand and meet their tax responsibilities.

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[68] *Hearing to Examine Tax Fraud Committed by Prison Inmates*, 109th Cong. (2005) (statement of J. Russell George, Inspector General) and *The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners* (TIGTA Reference Number. 2005-10-164, dated September 2005).

[69] Processing year refers to the year in which taxpayers file their returns at the Submission Processing Sites. Generally, returns for 2003 were processed during 2004, although returns for older years were also processed.

Conclusions

It is unlikely that a massive change in voluntary and timely compliance can be achieved without significant changes to the tax administration system. Regardless of whether a 90 percent VCR can be achieved, the IRS faces formidable challenges in completely and accurately estimating the tax gap and finding effective ways to increase voluntary compliance. Strategies have been identified to decrease the tax gap and improvements can be realized; however, sufficient resources are needed to ensure compliance with the tax laws.

Mr. Chairman and members of the subcommittee, I appreciate the opportunity to share my views on the tax gap and the work TIGTA has done in this area. I would be happy to answer any questions you may have.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Senate Finance Committee
Subcommittee on Taxation and IRS Oversight

Questions for the Record
A Closer Look at the Size and Sources of the Tax Gap
Testimony of July 26, 2006

Submitted by
The Honorable J. Russell George
Treasury Inspector General for Tax Administration

Senators Grassley and Kyl

1. **Compliance Comparison: How does the U.S. rate of voluntary compliance compare with that of other developed market economies?**

TIGTA has not evaluated how the U.S. rate of voluntary compliance compares with that of other developed market economies. We are aware that the Internal Revenue Service (IRS) is the only tax agency that performs a direct measurement of compliance such as the National Research Project.

We are aware of studies by economists that attempt to quantify the informal economies as percentage of Gross Domestic Product. Various economic methods are used to determine the size of economies and determine the size of the informal economies, which would include both legal and illegal source income. From the survey we have reviewed, the U.S. ranks favorably when compared to the other 21 Organization for Economic Cooperation and Development countries.

2. **Voluntary Compliance Goals: Your testimony includes a useful chart on revenue collections that would be needed to reach various voluntary compliance levels. The IRS has set a voluntary compliance goal of 85 percent; Senator Baucus has suggested 90 percent. What do you think is reasonable and achievable? And by what time would it be achievable?**

The purpose of the chart was to illustrate the significant additional tax that would have to be collected given the same factors as Tax Year (TY) 2001. To achieve significant increases in voluntary compliance, there would likely have to be multiple changes to both tax policy and tax administration. Given the current tools, the IRS' goal of 85 percent voluntary compliance by 2009 would be the threshold goal. According to one expert with whom we spoke, 90 percent voluntary compliance would be "remarkable."

However, if the recommended multi-faceted approaches are implemented, greater increases could be realized. The timeline most likely would be extended beyond 2009, but longer term benefits to tax administration would result.

3. **IRS Data: In your testimony, you make several criticisms of the Internal Revenue Service's data and statistics about the tax gap and compliance levels. One area you criticize is the accuracy of the "payments collected" estimate---this is the amount that determines the difference between the "gross tax gap" and the "net tax gap." You noted that the IRS estimates that it collects $55 billion from enforcements and late payments each year, and this estimate has been constant over some time, but it does not take into account changes in the IRS' ability to collect revenue.**

- **What do you mean by "the changes in the IRS's ability to collect revenue"? Has their ability to collect revenue improved or worsened?**

We were not able to determine how dated the methodology was to estimate collections against the tax gap. However, the formula goes back to at least the 1980s. Since that time, there have been substantial changes in the IRS' collection function. First, the size of the collection revenue officer work force has decreased by about 38 percent since 1995. In addition, there were substantial decreases in enforced collection actions, especially in TY 2001 when liens and levies were at or near their low points. Much of the decline is attributed to the Internal Revenue Service Restructuring and Reform Act of 1998, which had a significant impact on IRS collections. On the other hand, improvements have occurred in collection from reengineering efforts to identify the most productive cases. Our point was that the $55 billion is presented as a number derived from a tabulation of monies collected, when, in fact, it is an estimate based on an old formula for which only about half could be verified.

- **You note in your testimony that it is impossible to know if the $55 billion is ever collected. Would you also say that it is impossible to know if more than $55 billion is collected, possibly making the net tax gap smaller?**

Based on what can be verified, it is possible that more than $55 billion was collected. By definition, any payment that is collected after the due date is included. So, in the case of returns with extensions, if the payment is received after April 15, it is a late payment and would be counted in this total. This occurs even though there is a valid extended due date.

For example, we reported that the IRS granted extensions of time to file to approximately 6.9 million individual taxpayers in Calendar Year (CY) 1999. Many of these taxpayers subsequently presented the IRS with significant compliance problems. Approximately 2.1 million of these taxpayers did not pay their taxes by April 15, as required by the Internal Revenue Code (I.R.C.). This noncompliance delayed the collection of taxes totaling $12.7 billion, of which $8.5 billion was not collected in the fiscal year in which the taxes were due. Further, $1.5 billion of these taxes remained uncollected almost two and one-half years after they were due.

4. **<u>Sample Sizes and Audits</u>: Your testimony also questions the methodology of the IRS's tax gap estimate; in particular, you raise questions about samples and adjustments made to estimates.**

    - **Would you explain your concerns about the sample sizes used and how these could affect the accuracy of the data?**

Our concern was related to the size of the National Research Project (NRP) calibration sample. The calibration sample is designed to correct for detection errors by the revenue agents conducting the examinations. The calibration samples have to be of sufficient size to be used. The IRS performed the calibration sample; however, the expert who designed the calibration sample expressed concerns about the sample sizes. The accuracy could be adversely affected, depending on the extent of the error.

- **Would you discuss how we should balance our concerns with accuracy about the sample sizes with our concerns about subjecting taxpayers to more audits in order to gather better information? Or is there a way to gather better information without increasing the number of full scope audits?**

In general, we believe that accuracy, within desired confidence and precision levels, is of utmost importance. We agree that undue taxpayer burden needs to be avoided; however, the NRP methods are designed to be less burdensome than the Taxpayer Compliance Measurement Program (TCMP). Since the NRP results are also used for the examination return selection process, the benefit of accuracy extends to all taxpayers since tax returns with a higher likelihood of change are selected.

5. **<u>Enforcement vs. Simplification</u>: Inspector George, in your testimony you state that a significant portion of the tax gap may not be amenable to traditional examinations and audits and that tax law simplification and increased third party reporting might better address that portion. Can you please elaborate on what parts of the tax gap you are referring to, the reasons why additional enforcement may be inadequate and how simplification and information reporting might be more effective? Can you provide examples in the tax code that could be simplified?**

From a cost standpoint, examinations cost more than other methods for improving compliance. But, beyond that fact, conducting the NRP is very instructive. In order to account for undetected income, the IRS completes "calibration audits." Essentially, what this means is that the IRS must correct for undetected income items that the examiners miss. The final numbers are adjusted for this factor. So, as a point of illustration, if examiners only detect 50 percent of the actual unreported income during an examination, then only 50 percent of the tax gap caused by that taxpayer is detected. Since the tax gap has a substantial amount of underreported income that is not subject to information reporting, it may be more effective to devise third-party reporting systems rather than substantially increasing the number of examinations.

Some tax code areas that call for simplification are the Earned Income Tax Credit, the Alternative Minimum Tax and the education credit and deduction. I

would add to this list an issue we reported in May 2005. The employment taxes paid by single-owner shareholders of Subchapter S corporations can be manipulated by declaring low salaries. If this complexity were eliminated, reasonable compensation would not be an examination issue for Subchapter S corporations.

6. **Your written testimony discussed previous attempts to close the tax gap. I think that it is interesting that a 1993 report by the Treasury Department and the Office of Management and Budget determined that "enforcement is the most costly option and delivers only limited revenue." Do you agree? Do other witnesses agree?**

I believe that the 1993 report you are referring to was prepared by the Internal Revenue Service. In that report, the IRS concluded that enforcement is the most costly option and only delivers limited revenue. We believe that this is the case with many taxpayers for the reasons we stated in response to your previous question. In addition, in a recently issued TIGTA audit report on high-income taxpayer examinations, we reported that the IRS has increased the number of high-income taxpayer examinations substantially in recent years. But, the results are less than optimal. In FY 2004, the IRS assessed over $2.1 billion in additional taxes on high-income taxpayers through its Examination program. This figure includes assessments of $1.4 billion (66 percent) on taxpayers who did not respond to the IRS during correspondence examinations. Based on our statistical sample of cases, we estimated that approximately $1.2 billion (86 percent) of the $1.4 billion has been either abated or not collected after an average of 608 days, almost two years, from the date of assessment.

While there is clearly a need to perform them, examinations are a costly method when used as the primary method to close the tax gap.

- **The same report found that "methods to increase voluntary compliance are less costly but more burdensome to taxpayers." Is this referring to increased reporting and or withholding? Or to other options?**

The report contained many recommendations that addressed both increased information reporting and increased withholding. While there were other recommendations for changes, such as requiring that businesses and licensed professionals obtain a certificate of the filing and payment of taxes in order to operate, many recommendations focused on increased information reporting and withholding.

- **The report made several other recommendations that still might be instructive. Perhaps the most interesting revelation is your comment that TIGTA was unable to determine if the report's recommendations**

were implemented. Do any of the other witnesses know if any of the recommendations were implemented?

We defer to the other witnesses to indicate their knowledge of whether recommendations were implemented and whether the implementation was directed toward correcting the condition identified in the study.

7. **Cost-Benefit Analysis of Information Reporting: The GAO testimony notes that "designing new withholding or information reporting requirements to address underreporting can be challenging given that many types of income are already subject to at least some form of withholding or information reporting, there are various forms of underreporting, and the requirements could impose costs and burden on third parties.**

    - **Can you recommend other ideas for innovative solutions for improving information reporting or withholding that would not impose unreasonable burden on taxpayers?**

Two ideas were detailed in the 1993 study. The first concerns the business certification concept. There are many details that would have to be addressed; however, the core concept would place the burden on the taxpayer to ensure that taxes were filed and paid before a business certification was obtained.

The second area is what is called the "reverse information reporting program." The idea is that some taxpayers do not send in required information documents when they are required. Several studies have shown considerable increases in compliance when third-party reporting exists.

Neither of these approaches would pose significant additional costs or burdens on third parties.

    - **How do you recommend Congress balance the need for additional information with the need for taxpayers to not have unreasonable recordkeeping or reporting burdens placed upon them?**

We believe that recordkeeping is a requirement of business. While there are differences in accounting recordkeeping practices and tax recordkeeping, transactions require recordation. Thus, information reporting based on what would already be expected recordkeeping does not seem as though it would cause an undue burden for businesses operating in the business environment.

8. **Business Income Underreporting: Inspector George, we've heard from all our panelists this afternoon that addressing the tax gap will involve increased enforcement, more information reporting and tax code**

simplification. According to IRS estimates, the largest chunk of the tax gap - $109 billion – is from underreported net business income by individuals. Can you please explain the roles that enforcement, information reporting and tax code simplification might play in reducing this component of the tax gap? Are there other measures that might address this component?

While our work has not directly addressed these specific issues, we have gathered information concerning your inquiry. For example, some economists believe that one of the reasons why taxpayers choose to underreport income (participate in a shadow economy) is based on the burdens of social taxes and the cost of complying with government requirements. Thus, for some noncompliant taxpayers, the tax compliance challenges may be significantly more difficult to overcome.

For the small business or informal cash-basis taxpayer, enforcement achieves some benefits. Although we believe that enforcement has some deterrent effect, this effect may be minimal for some taxpayers. Additionally, when a taxpayer is examined and additional tax is assessed, the question then becomes whether the assessment will be collected.

For certain businesses, information reporting could effect greater compliance. We do believe that when there is a change in tax compliance actions, they be vigorously enforced with the initial implementation. So, a strong information return program with sufficient follow-up could increase compliance by certain taxpayer groups where this would apply. For the most part, this would be the independent contractor. Whereas, for other taxpayers, such as small food service industry owners, the information reporting would have to be based on something similar to the reporting of gross deposits by banking institutions.

Tax simplification for small business taxpayers is a critical issue because of the costs associated with tax compliance. The Tax Foundation estimates that in CY 2000 it was 27 times more costly based on asset size for a small business taxpayer to comply with the tax laws than the largest firms. One method to avoid these costs is either to not comply or to minimize the efforts to comply. So, from the business perspective, a taxpayer may have to choose between paying higher costs to be tax compliant and avoiding tax compliance to reduce costs.

9. **<u>Additional Funding</u>: If Congress were to provide the IRS with additional funding to bolster its enforcement activities, what kind of return could we expect from that investment and when could we expect to see it?**

We defer a specific response to this inquiry to the IRS. However, based on our audit of the return on investment model, we believe that the IRS does not have sufficient information to provide accurate estimates of future revenue that would be realized from increased enforcement investments.

10. Under current law, the IRS is required to keep accounts receivable on the books for ten years – and thus amounts that it knows are uncollectable cannot be written off for that period. Would it make sense to reduce that to a shorter length of time so that we have a truer picture of the accounts receivable inventory – e.g. six years?

We defer the response to this question to the IRS and the GAO.

Senator Hatch

1. I've read your approaches to reducing the tax gap with interest. How many of your recommendations depend upon legislation and which might be done by the IRS? I know that simplifying the tax law falls under our purview, but it seems that many other recommendations may not require action by Congress. Does political pressure make certain strategies for closing the tax gap more problematic, in your opinion?

TIGTA made specific recommendations to the IRS concerning estimating the tax gap. However, we are in agreement with the other panelists about the methods needed to reduce the tax gap. The three major methods for reducing the tax gap are increased enforcement, increased third-party reporting and tax law simplification. While I am not able to comment on the impact of political pressure, we believe that actions by Congress are needed in all three of these areas. Increased enforcement requires a larger IRS budget to hire, train and retain enforcement personnel. Increased third-party reporting will require changes in the tax law. And, as you stated, tax law simplification is under congressional purview.

The IRS must maintain a balance between enforcing the Internal Revenue Code and ensuring that taxpayers' rights are protected. While there are enforcement strategies that could help reduce the tax gap, some taxpayer rights protection laws prevent the IRS from using these strategies.

2. Where would we get the most bang for our buck from additional resources being dedicated to reducing the tax gap:

- **Auditing estate returns**
- **Auditing corporate returns**
- **Auditing High-Income individual returns**
- **Improving the IRS computer capabilities**

- **Improving the forms or the instructions, or**
- **Something else?**

We believe that increased enforcement, greater computer capabilities, and clearer forms and instructions are all important elements in reducing the tax gap. With limited resources available, choices do have to be made. Senator Baucus has requested that the IRS provide a strategic approach to reducing the tax gap with detailed information concerning the causes, actions to be taken, and a timetable. We defer a response on this inquiry until we have had the opportunity to fully evaluate the IRS plan.

Senator Baucus

1. Identify and discuss the five primary causes of the tax gap.

Although TIGTA has not performed audits or evaluations on the primary causes of the tax gap, in our efforts to better understand the tax gap, we have conducted research on attributed causes. While these may not be the five primary causes, we believe that each is a major contributor.

Tax Law Complexity –

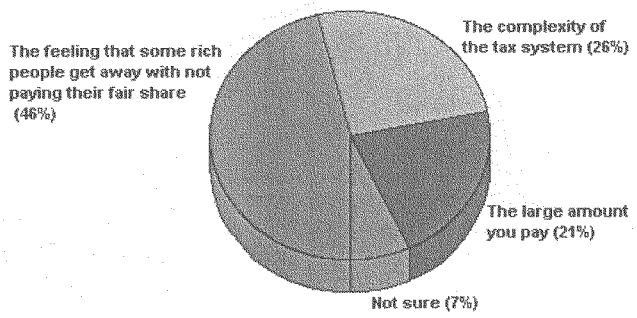
Whether complexity itself causes the tax gap because of confusion or whether complexity increases avoidance/evasion and leads to higher costs to comply, tax law complexity is seen as a major contributor to the tax gap.

Perception of fairness –

The non-partisan organization Public Opinion reported on a survey that more taxpayers are bothered that the rich may not be paying their fair share than any other concerns about the tax system.

Many Americans say when it comes to taxes they are most bothered by the feeling that some rich people get away without paying their fair share

Which of the following bothers you most about taxes: the large amount you pay in taxes, the complexity of the tax system, or the feeling that some rich people get away with not paying their fair share?



Source: Fox News / Opinion Dynamics 3/99

The perception of fairness is the view that corporations and rich individuals have loopholes that allow them to not pay taxes. So, taxpayers may be inclined to devise their own methods to avoid or evade taxes.

Increased Cost of Social Taxes –

Economists who study the shadow economy globally identify that the costs of social taxes cause businesses to avoid or evade taxes. There is also growing evidence that the increased costs of social taxes cause employers to hire "independent contractors" who may be undocumented workers, or to simply pay employees "under the table." Studies by economists on the shadow economies world-wide attribute tax evasion to the additional costs of social taxes.

Cost of Compliance –

The cost of compliance is linked with the increased cost of social taxes by the same economists. Beyond this, the non-partisan Tax Foundation found that the cost of compliance is 27 times greater as a percentage of assets for a small firm when compared with the largest firms.

The Use of Tax Havens to Avoid Taxation –

In August 2006, the Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, issued a report entitled, "Tax Haven Abuses: The Enablers, The Tools, and Secrecy." The report recommended that Congress empower the Department of the Treasury to eliminate tax benefits in havens that do not cooperate with U.S. authorities.

Americans have an estimated $1 trillion offshore in about 50 havens — including Belize, the British Virgin Islands, the Cayman Islands, the Isle of Man, Nevis, and Panama — that impose little or no taxes on non-residents. The estimate is that U.S. taxpayers are avoiding approximately $40 billion a year in taxes through tax havens.

2. **To what extent is the IRS directing its resources toward the primary causes of the tax gap? What measures are used to determine whether the IRS's efforts constitute the optimal use of resources to improve voluntary compliance and close the tax gap?**

We defer this question to the IRS since we have not performed an evaluation to determine if the IRS is directing its resources toward the primary causes of the tax gap. Additionally, we have not performed any recent comprehensive reviews on the IRS measures related to improving voluntary compliance and closing the tax gap.

3. **Identify and discuss the five primary impediments to voluntary compliance.**

We defer this question to the IRS since we have not performed an evaluation of the primary impediments to voluntary compliance. We believe that the primary impediments to voluntary compliance are juxtaposed to the causes of the tax gap. For example, tax law complexity is identified as a cause of the tax gap while an impediment to voluntary compliance is understanding the tax law.

4. **Identify and discuss the five primary burdens of taxpayers in meeting their tax obligations.**

We defer this question to the IRS since we have not performed an evaluation of the primary burdens on taxpayers in meeting their tax obligations. From our efforts to provide oversight to tax administration, we have gathered information concerning taxpayer burden. In general, taxpayer burden is defined as the time a taxpayer spends and the monetary outlay required to comply with the tax laws.

The IRS contracted with IBM to develop an Individual Taxpayer Burden Model that identified 21 attributes to determine taxpayer burden. These were divided into source attributes (a line item that requires information from a source), operation attributes (a line item that requires the taxpayer to perform an operation at least once) and complexity attributes (each instance of the attribute in the instructions for a line item that refers you to a tip, exception to the rule, publication, etc.) We have not evaluated this model.

However, in our risk assessments, we have identified burdens that taxpayers face in complying with the tax system. While these may not be the five primary taxpayer burdens, we believe each has a major effect on burden.

Tax Law Complexity/The stability of the tax law –

Complexity adds to taxpayer burden because of the additional forms, worksheets, publications, guidance and effort it requires. Likewise, changes in the tax laws require taxpayers to evaluate and research the effect of the changes on their own tax situations. This is especially true of business taxpayers who must constantly be up-to-date on tax law changes that affect their businesses.

Timeliness of Compliance Actions/ Cycle time to close –

The time between return filing and a compliance contact is usually 18 to 24 months. This requires the taxpayer to provide records that can be difficult and time-consuming to assemble. At times, the individuals who initially assembled the records are no longer available to retrieve or interpret the records. Likewise, the time to close examinations for some large taxpayers can be three to four years. So, there can be substantial burdens on taxpayers when compliance issues arise.

Access to IRS –

Taxpayers need varying levels of assistance to resolve their problem. This may be self-service, speaking with a toll-free Customer Service Representative, speaking with a Taxpayer Assistance Center tax assistor, or contacting a compliance employee about a tax law compliance or payment issue. However, a taxpayer may not always be successful in achieving the method of contact that he or she chooses. Taxpayers may have to make many attempts to get their problem/question resolved. When contacts are made, the IRS employees may not always be knowledgeable about the tax law to the extent needed to satisfy the taxpayer's requirements. So, one-stop customer service may not be achieved.

Cost of recordkeeping/preparation/return filing –

Taxpayers' recordkeeping consumes time and resources. Businesses may be required to keep separate tax and accounting records for such items as depreciation. Likewise, some taxpayers may be required to determine their taxes twice, as with the Alternative Minimum Tax. Fees for return preparation range from reasonable to excessive.

Competency of Paid Preparers –

Recent attention has been given to the competency of some tax preparers with a focus on regulating tax preparers. A tax preparer can cause taxpayers significant hardship and burden when the preparer is incompetent or attempts to perpetrate fraud.

5. Identify and discuss the five primary concerns of IRS stakeholders.

We defer this question to the IRS since we have not performed an evaluation of the primary concerns of stakeholders. However, as part of our annual risk assessment, we identify some concerns of stakeholders. The following concerns have been articulated by one or more stakeholder groups (The American Bar Association (ABA), the American Institute of Certified Public Accountants (AICPA), the National Association of Tax Practitioners, National Association of Enrolled Agents, the Tax Executives Institute (TEI), the National Council for Taxpayer Advocacy, the National Association of Tax Professionals, the National Society of Accountants)

Tax Reform –

Input to the discussion on the direction of tax reform and the Presidents Tax Reform Panel recommendations

Tax Law Simplification –

Issue discussed by AICPA, ABA and TEI

Concerns about Uniform Definition of Child –

The Working Families Tax Relief Act of 2004 (Pub. L. No. 108-311) replaced multiple definitions of "child" used for child-related tax benefits in the Internal Revenue Code with a uniform definition of "qualifying child" (UDOC). An additional change to the UDOC was made as part of the Gulf Opportunity Zone Act of 2005 (P.L. 109-135). The UDOC had been sought by the National Taxpayer Advocate, the staff of the Joint Committee on Taxation, and some professional organizations. The primary purpose of the UDOC (aside from simplifying the definitions themselves) was to make many child-related tax benefits rise or fall together as a single group. However, there have been significant concerns raised by several stakeholders about the possible unintended consequences of the changed definition.

Concerns about Customer Service and Efforts to Increase Enforcement –

The stakeholders' concern is that after the many improvements the IRS has made over the past several years in customer service, there are indications that the IRS is returning to the "old school" way of conducting business. The concern is that with the increased emphasis on enforcement, the IRS will have a decline in customer service. Stakeholders believe that customer service is vital to voluntary compliance.

Regulation of Tax Preparers –

Stakeholders support the proposal to regulate those who prepare tax returns for a fee. The professional organizations are generally in favor of some type of regulation over tax-return preparation service.

6. Identify and discuss the five most significant impediments to the IRS's efficiency and effectiveness. What is the IRS doing to eliminate or mitigate these impediments?

We defer to the IRS to discuss what it believes are its five most significant impediments to efficiency and effectiveness. We have not performed an evaluation and, therefore, lack sufficient specific evidence to provide an opinion. However, in our efforts to assist tax administration in improving efficiency and effectiveness, we have identified some impediments.

Tax Law Complexity –

As we have reported in our Major Management Challenges assessment, tax law complexity can add significant costs to IRS operations as well as increase taxpayer burden. Complexity has been discussed in many other contexts; however, one major effect of complexity is on the IRS's ability to operate efficiently and effectively in virtually every aspect of tax administration. The affected operations range from form design complications to establishing Advanced Pricing Agreements. Tax law complexity adversely affects efficiency and effectiveness.

IRS Computer Modernization –

Until computer modernization is substantially realized, anticipated efficiencies in operations will not be maximized. As reported in our Major Management Challenges assessment, the IRS Computer Modernization has been reported as a concern for several years. Since FY 2002, our annual Business Systems Modernization (BSM) assessments have cited four primary challenges that the IRS and its contractors must meet to achieve program success: 1) implement planned improvements in key management processes and commit necessary resources; 2) manage the increasing complexity and risks; 3) maintain the continuity of strategic direction; and 4) manage contractor performance and accountability effectively. The program is in its seventh year and has allocated approximately $2.1 billion for contractor and integrator activities.

One failed project that has received significant attention has been the Electronic Fraud Detection System (EFDS). While EFDS was not under the Modernization project umbrella, it encountered many of these problems.

IRS Business Reengineering Efforts –

As we have reported in our Annual Major Management Challenges assessment, the IRS is making progress; however, the long-term effectiveness cannot yet be evaluated. The IRS has been implementing reengineering projects designed to increase the effectiveness of enforcement efforts. We have conducted several reviews of these initiatives; however, further assessments will have to be made to determine the longer-term effectiveness of the changes.

IRS Productivity Measurement –

The General Accountability Office (GAO) issued a report entitled, "IRS Can Improve Its Productivity Measures by using Alternative Measures." The report addressed the measures the IRS used to determine the efficiency with which inputs are used to produce outputs, or productivity. We believe that what is being measured and used to define productivity has a significant impact on both efficiency and effectiveness. Therefore, the IRS productivity measures can be an impediment to increased efficiency and effectiveness.

Human Capital Strategies –

The ability to retain, recruit, hire, and train a highly skilled workforce can act as an impediment to gaining efficiencies and effectiveness. The extent to which the IRS is successful in strategically managing the workforce will have a direct impact on its overall productivity.

7. Identify and discuss the five most significant resource challenges facing the IRS.

We defer the response to this question to the IRS. We have not performed an evaluation and therefore lack sufficient specific evidence to provide an opinion. However, in our efforts to provide oversight for tax administration, we are aware of some significant resource challenges.

Business Systems Modernization –

Both the GAO and the IRS Oversight Board advised the Senate Appropriations Committee that IRS Business Systems Modernization should receive more funding in Fiscal Year 2007 to accelerate its progress. The GAO testified that the IRS has put its modernization program on track after years of schedule delays, cost overruns, and management problems. We believe that some increases are merited; however, we have not developed a quantified estimate.

Sufficient Staffing to Support National Research Projects

In our review entitled, "Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections," we expressed a concern about whether the IRS would have sufficient funding to continue performing National Research Projects to ensure that sample sizes were of requisite size and that they could be performed on a regular basis.

Sufficient Staffing to Provide Quality Customer Service –

The IRS has to make resource decisions that affect its ability to provide quality customer service and to enforce the tax laws. In the past year, the IRS had announced that it would close 60 TAC sites and reduce toll-free service from 15 to 12 hours a day. We believe that these types of decisions should be based on the use of high-quality decision support data and not just a shift of resources from customer service to enforcement.

Tax law enforcement –

The IRS audit coverage rate needs to be maintained or increased to ensure that noncompliant taxpayers are brought into compliance and to foster voluntary compliance. Likewise, the IRS needs sufficient resources to actively contact taxpayers who are not payment compliant.

While each of these areas requires additional resources, adding resources needs to be done on a regular basis over a period of time. Past experience has shown that increases in resources can actually reduce the IRS's effectiveness, since the organization has a limited capacity to absorb and train new hires.

8. Identify and discuss the five primary impediments to delivering top quality customer service.

We defer the response to this question to the IRS. We have not performed an evaluation and, therefore, lack sufficient specific evidence to provide an opinion. However, based on our risk assessments, we have identified impediments to delivering top quality customer service. Tax law complexity affects all customer service issues. In addition, many of the impediments are interrelated. We have identified the following impediments to delivering top quality customer service:

The IRS has not had an overall Customer Service Strategy –

The IRS has had Concepts of Operation but not a Customer Service Strategy based on a solid business case supported by decision support information and customer input. The process has started with the Taxpayer Assistance Blueprint, but this will not address the concerns with the IRS's reported problems relating to incomplete and inaccurate decision support data.

Also, the IRS does not have a cross-functional (corporate) approach to customer service and consistency is lacking between offices and functions. The offices and functions delivering customer service have competing priorities and budgets, and different objectives and goals. In addition, the IRS operating units function separately from the other units, and there appears to be a lack of communication or cooperation.

The IRS does not have accurate and reliable management information –

TIGTA audits have raised concerns regarding the reliability of Field Assistance Office management information as a basis for making business decisions. In 2005, we reported that since the creation of the Field Assistance Office in October 2000, key management information used to make decisions and support changes is either absent, incomplete, or inaccurate. For example, the IRS does not have accurate and complete data to make appropriate decisions when determining the locations and services it provides taxpayers seeking face-to-face assistance. In addition, the IRS used inaccurate and incomplete data when recommending closing 60 of 400 Taxpayer Assistance Centers.

The IRS also does not have sufficient measurement control points to capture decision support data. For example, we recently reported that the IRS Field Assistance Office does not have accurate data to determine the quality of its assistors' responses to tax law and accounts inquiries. In addition, audit results continue to show that Field Assistance Office data is not accurate on what services it provides at the Taxpayer Assistance Centers; therefore the IRS cannot effectively determine what services taxpayers use or need.

Finally, the IRS has not determined the effect of customer service on compliance. The IRS has conducted only limited research on the impact of customer service on taxpayer compliance. Therefore, there are not sufficient data available to measure the effect on taxpayer compliance. Both the National Taxpayer Advocate and the GAO have expressed concerns about this lack of data.

The IRS Customer Service operation does not have sufficient activity-based costing information to provide a basis for decision making –

The IRS does not have an integrated financial management system that will provide accurate and timely cost data at a program or activity level. This prevents the IRS from calculating return on investment and comparing customer service options to ensure that the most cost effective methods are being used or explored.

The IRS sets customer service goals based on its own budget allocations rather than taxpayer needs/requirements –

The IRS does not have accurate measures or sound business cases for all services provided. Because it has not fully evaluated the service needs of taxpayers, it has not determined the types and levels of service that will fulfill taxpayer needs so that the budget can be allocated to provide the optimum levels of service for each of the types of service provided. Instead, the IRS allocates the funds then determines what level of service can be provided based on the allocation. If the IRS properly implements the concept of the Taxpayer Assistance Blueprint, which it was required to develop by statute, it should be able to improve its service levels by properly evaluating taxpayer needs and service delivery channel preferences before allocating its budget.

The IRS Customer Service operations are not designed to provide one-stop service –

Taxpayers still, for the most part, cannot obtain one stop service. When calling on the telephone, taxpayers are transferred between applications – one assistor cannot answer both a tax law question and an account question. Taxpayers cannot get answers to complex tax questions at the Taxpayer Assistance Centers. The IRS does not offer account services on-line.

9. Identify and discuss the five primary technological impediments the IRS is facing.

Complexity of the Tax Law –

The complexity of the Internal Revenue Code has resulted in complex computer systems and programs. The IRS has experienced difficulties in stating the complex requirements of existing systems so that contractors are able to understand the intent, nuances, and implications of these requirements for use in building new systems.

Computing Capacity –

The amount of needed computing capacity and its cost continue to increase as new modernized systems are built. Some estimates indicate that the IRS will need a ten-fold increase in computer capacity (millions of instructions per second) to handle the new modernized systems compared to the current processing environment. In addition, many current IRS systems must continue to operate until the long-term systems modernization effort is complete. Therefore, the IRS' ability to manage and pay for growing computing capacity needs will be difficult.

Adequate Skills –

The IRS has reported difficulties in hiring and retaining skilled programmers and systems engineers who are needed to design, develop, and maintain effective and efficient computer programs for the IRS' modernized systems.

Availability of Data –

The IRS has not yet built the Account Management Services computer systems needed to allow access to tax return information contained in the new Customer Account Data Engine (CADE) databases. These systems are needed to allow IRS employees on-demand access to update taxpayer information. In addition, the IRS has not yet determined how data warehouses or repositories will be used to provide historical data for employee use and analysis.

Modernization Vision and Strategy –

The most recent update to the IRS' Modernization Vision and Strategy contains several projects that could have an impact on the tax gap. However, implementation of these projects is partially dependent on the use of new technology and tools that have not yet been successfully used in the IRS processing environment (e.g., Business Rules Approach, Integration Broker Services, and Service Oriented Architecture).

10. Identify and discuss the five primary collection impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?

We defer the response to this question to the IRS since TIGTA has not performed an evaluation with supporting evidence as a basis for our opinion. However, we have gathered information in our oversight of tax administration that may provide additional information concerning the impediments to collection.

Revenue Officer Staffing Levels –

Overall, the level of collection activities and the results obtained in many Collection function areas in FY 2005 showed a continued increase, as in recent years. However, a significant impediment has been that Collection Field function staffing (face-to-face Revenue Officers) at the end of FY 2005 was 3,680, which was 38 percent lower than the staffing in 1996. The FY 2006 budget for tax law enforcement provided a 7 percent increase over the FY 2005 budget, and both Collection and Examination functions plan to hire enforcement personnel during FY 2006. While the President's FY 2007 proposed budget for tax law enforcement is a slight increase over the FY 2006 budget, additional funding would be needed to maintain the same level of service provided for in the FY 2006 budget. Overall staffing is one of the biggest impediments that the IRS

has in the Collection area. More staffing could lead to more tax dollars being collected and more accounts being resolved sooner in the collection process.

Modernization of Filing and Payment Compliance Systems –

Modernizing the information technology and updating the antiquated computer system is a challenge for the IRS. The Filing and Payment Compliance computer system is taking longer to complete than anticipated. The system will eventually help the Collection division with inventory management, case workload management and case resolution tools. The modernization will make the division more efficient and effective.

Abuse of Intended Safeguards –

Some taxpayers are abusing the safeguards enacted by Congress and are using these provisions to improperly delay collection and impede tax administration. For example, some taxpayers are basing their offer in compromise or Collection Due Process (CDP) hearings requests on frivolous arguments and are thus delaying the collection process.

Federal Payment Levy Program Constraints –

There are so many rules and regulations regarding the use of the Federal Payment Levy Program (FPLP) that it has limited the IRS' filing of levies in certain situations. Several of these regulations came about after RRA 98 was enacted. Congress, the Department of the Treasury and the IRS should evaluate these constraints to aid in the collection process. For example, the IRS cannot now levy until the taxpayer has been notified and they are offered a CDP hearing. If the taxpayer requests a hearing, then the IRS cannot levy until resolution of the hearing and judicial review.

Section 1203 Effects on Enforced Collection Actions –

The use of a seizure as an enforcement tool was at its peak in FY 1996 when the IRS conducted 10,449 seizures. Conversely, there were only 74 seizures in FY 2000. Since FY 2000, the number of seizures has increased slowly and in FY 2005, there were 512 seizures. While the numbers are still substantially lower than they were before 1998, it is unlikely the IRS' use of seizures will ever return to the pre-1998 levels. After congressional hearings in 1997, the IRS instituted several new policies and procedures regarding the seizure of a taxpayer's property. Now the seizure process is very time-consuming for revenue officers.

Also, liens and levies are rebounding from post-RRA 98 drops, but they are still not back to the pre-RRA 98 levels. One reason for the drop in enforcement is some of the stringent controls put in place after the 1997 congressional hearings. Revenue officers sometimes appear to be very cautious in enforcing the laws

due to fear of the taxpayer filing a complaint (Section 1203 of RRA 98) against them but also due to laws that now require the taxpayer to be notified before a third party is contacted.

We fully agree that protecting taxpayers from IRS abuses is important to the integrity of tax administration. At the same time, these laws should not protect noncompliant taxpayers from necessary enforced collection actions.

11. Identify and discuss the five primary examination impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?

We defer response to this question to the IRS since TIGTA has not performed an evaluation with supporting evidence as a basis for our opinion. However, we have gathered information in our oversight of tax administration that may provide additional information concerning the impediments to examination.

Section 530 –

There are substantial impediments for the IRS to administer the employment tax laws. IRS management states that since 1978, it has been prohibited from issuing any new guidance concerning whether a worker is an employee or an independent contractor. This presents a problem because the work environment has changed significantly since 1978 in the way businesses operate and how workers are classified by businesses. The issue of worker classification (and potential misclassification) has been ranked as one of the IRS Small Business/Self-Employment Division's top priorities. Data analysis shows that the misclassification of employees as independent contractors reduces their overall rate of compliance from 92 percent to 84 percent.

Assessment Statute Expiration Date Limitation on Abusive Transactions –

Congress, the Department of the Treasury and the IRS consider identifying and combating abusive tax shelters as extremely important to sound tax administration. Abusive shelters cost the Treasury an estimated $85 billion a year. TIGTA recently reviewed how the IRS addressed one tax scheme. A provision in the American Jobs Creation Act of 2004 (AJCA) provided the IRS with up to one additional year to assess taxes related to a "listed" transaction if it is not properly disclosed on the return. Despite the positive, open-ended feature in the AJCA provision, TIGTA's review of the specific tax scheme found that the one-year limited extension does not accurately reflect the time needed to complete the examination and assessment process involved in resolving complex, technical abusive tax shelters. As a result, the one-year limited extension in the AJCA could prove overly restrictive to realizing intended benefits from the extended assessment period.

Sheltering Of Income in Tax Havens –

In recent years, a significant increase in offshore activity has been noted among U.S. taxpayers. More and more taxpayers have been observed attempting to "expatriate" their income and assets. Numerous schemes have been devised in which the true ownership of income streams and assets has been hidden or disguised. Substantial amounts of financial activity have been improperly shielded from the IRS and the U.S. tax system.

There are barriers for the Examination function to obtain records, and it is often a very slow process. In August 2006, the Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations issued a report entitled, "Tax Haven Abuses: The Enablers, The Tools, and Secrecy." The report recommended that Congress empower the Department of the Treasury to eliminate tax benefits in havens that do not cooperate with U.S. authorities.

Information Reporting on Small Business and Self Employed Taxpayers –

IRS statistics show that there is 90 percent compliance when there is third-party reporting. In the small business and self-employed arena, where there is a lack of both third-party reporting and withholding, the IRS states that there is only about 55 percent compliance. Increasing audit rates and selecting better returns to examine can help; but auditing one individual at a time will not help the IRS make significant strides in closing the tax gap. Increased third-party reporting is often suggested as a method to increase voluntary compliance. One proposed reporting measure is to require the reporting of aggregate credit card receipts received by business owners to obtain an idea of how much income is being received (proposed in the President's 2007 budget request for the Department of the Treasury). The IRS has estimates of the ratio between credit card receipts and cash received in a business and could use this in the determination of which tax returns to examine.

Book-Tax Differences for Large Corporations –

TIGTA has recommended that the IRS make electronic filing mandatory for large corporate taxpayers. The IRS implemented this recommendation, and it has provided significant benefits in terms of substantially improving the timeliness of tax return availability and the amount of information that is available electronically. The IRS has improved the book-tax reconciliation schedule or the M-3. Substantial differences between book-tax can identify areas that require examination by the IRS. We concur with the IRS that to the extent that these differences have to be examined, there may be a benefit to tax administration to reduce the size and number of areas where there would be a large difference.

12. To what extent will the high percentage of retirement-eligible employees at the IRS impact the tax gap within the next five years? Ten Years?

We defer the response to this question to the IRS since TIGTA has not performed a comprehensive evaluation of this issue to provide the evidence as a basis for our opinion. However, TIGTA has gathered some information in our oversight of tax administration role that may provide additional information on this issue.

The IRS is meeting its hiring goals to replace retiring enforcement employees. Whether these employees perform below, at the same, or at higher levels than retiring employees is not yet known. We believe that the impact of the high percentage of retirement eligible employees on the tax gap will depend on several factors. Human Capital management is composed of five systems described by the Office of Personnel Management as the Human Capital Assessment and Accountability Framework (HCAAF). To the extent that the IRS plans, implements, and evaluates results of the HCAAF effectively, the impact of retirements may be less severe.

While Human Capital management is extremely important for the IRS to address to impact the tax gap, we believe that new work processes and technology will also have to be effectively implemented for the IRS to be efficient and effective. If the IRS implements new technology and reengineers processes, there will be a learning curve for both new and experienced employees. That scenario would reduce the impact of the impending retirements.

13. What is the IRS doing to retain experienced employees eligible for retirement?

We defer to the IRS on what is being done to retain experienced employees since we have not performed a review of this issue.

14. Describe the IRS plans to transfer knowledge skills and abilities from experienced workers to new workers, and to hire workers to replace employees who retire.

TIGTA recently completed a review of the Human Capital program in the Large and Mid Size Business Division (LMSB). We found that the LMSB developed a hiring plan to align with the strategies, goals, and priorities of the Division. Qualified applicants have been hired both internally and externally. LMSB is also beginning to develop its own internal pool of qualified applicants through intern and coop programs. LMSB is working with the IRS Human Capital Office to develop competency models for the majority of positions within LMSB. Once these models are completed, they will enable LMSB to conduct workload studies for the next four to five years.

LMSB is using a coaching program to transfer the knowledge of its experienced staff to its newly hired employees. Succession planning is a priority for LMSB as over 50 percent of its management and executive staff will be eligible for retirement by October 2008. LMSB has taken steps to develop its own succession planning model to prepare for these future vacancies. The succession planning model is scheduled for completion by the end of December 2006. Finally, LMSB is using three programs to develop its management cadre: Executive Readiness, Senior Manager Readiness, and Aspiring Team Manager.

We have not performed a similar review of Small Business/Self Employed (SB/SE) so we have no comments concerning knowledge transfer. However, we are aware that the SB/SE has hired or plans to hire about 1,800 positions in FY2006.

15. The Committee has requested Treasury and the IRS to submit a credible, comprehensive plan by September 30, 2006 to close the tax gap.

a. To what extent will having a plan help close the tax gap?

We believe that a credible, comprehensive plan will show what actions need to be taken by the IRS, the Department of the Treasury and Congress to close the tax gap. A plan will show the areas that require the most attention, what legislative changes are required, what customer service and outreach efforts are needed, and what enforcement actions are needed.

b. Are the Treasury and the IRS capable of developing a credible and comprehensive plan by September 30, 2006?

TIGTA defers to the Department of the Treasury and the IRS concerning whether a credible and comprehensive plan can be developed by September 30, 2006. We believe that the plan is the first step; however, the implementation will provide additional information and feedback to further refine the plan.

c. Describe what such a plan should look like, for example, what priorities, goals, benchmarks and measures do you think should be included in a tax gap plan? Discuss the appropriate allocation of resources among service, enforcement and technology as part of your response.

TIGTA defers to the IRS on the specifics of designing a tax-gap reduction plan. At a minimum, we believe that each tax gap component should start with the total taxes and number of taxpayers there are in the component and compare those figures to the noncompliance levels.

We suggest a Strength, Weakness, Opportunity and Threat analysis upon which various strategic approaches could be evaluated. For example, if small business taxpayers in a service industry are identified as a large component of noncompliant taxpayers, then the IRS could determine what types of actions, at what resource levels, would be most effective. If this population was determined to be millions of taxpayers, then one-on-one examinations would not be a likely cost-effective method. Thus, other strategies that are more efficient and effective would be developed.

Finally, we believe that the critical factors for success must be identified. This would identify the vital few factors that must be achieved in order for the IRS and Congress to substantially reduce the tax gap.

d. To what extent can existing IRS strategic and action plans regularly prepared by operating divisions and other functions be used toward developing a comprehensive tax gap plan?

We defer to the IRS on the specifics of developing the tax gap reduction plan. We believe that there is some information available from existing plans; however, because of concepts such as balanced audit coverage, there is the likelihood that resources are not distributed to maximize revenue.

e. To what extent can recommendations from the IRS Oversight Board, the National Taxpayer Advocate, the Government Accountability Office, the Treasury Inspector General for Tax Administration, the National Treasury Employees Union and non-governmental stakeholders be used toward developing a comprehensive tax gap plan?

We defer to the IRS on the specifics of developing the tax gap plan. We believe that many valuable recommendations have been made over several years. However, specific recommendations would have to be evaluated to determine whether the recommendation remains viable and is cost effective.

16. Please provide the results of the most recent "TIPS" (Trends, Issues, Problems) reports for each operating division and major function.

We defer to the IRS to provide the TIPS reports.

17. Please provide the most recent Strategic Action Plans for each IRS operating division and major function.

We defer to the IRS to provide the Strategic Action Plans.

18. Provide examples of instances when the Treasury and the IRS have developed plans in response to unanticipated circumstances or

legislation containing effective dates very soon after the date of enactment.

We defer to the Department of the Treasury and the IRS to provide examples and instances. From our reviews, we are aware that the IRS successfully prepared for and executed the Rate Reduction Credit Recovery Program. As of October 2002, credits totaling nearly $77 million were posted to the accounts of approximately 1.6 million taxpayers. The posting went as planned, and, aside from some minor problems, all eligible taxpayers received the credit amounts to which they were entitled.

The preparations for posting the additional credits were comprehensive. The IRS prepared and followed a detailed action plan, with associated deliverable dates. The action plan included items necessary for the successful execution of the program, including coordination with other IRS functions and other affected agencies, such as the Financial Management Service.

Two other examples relate to hurricane relief. The 2006 Filing Season was unusual due to the significant tax law changes to assist taxpayers adversely affected by the devastation caused by Hurricanes Katrina, Rita, and Wilma that struck the Gulf Coast States in August and October 2005. The Katrina Emergency Tax Relief Act of 2005 (KETRA) was signed into law on September 23, 2005, and contained $3.3 billion in estimated tax relief for Fiscal Year 2006. The GO Zone legislation followed in December 2005, with an additional $3.9 billion in estimated tax relief for 2006. Taxpayers who were adversely affected by the hurricanes were able to elect to use their 2004 earned income to calculate their Earned Income Tax Credit (EITC) and refundable Child Tax Credit, double their Hope and Lifetime Learning Credits for students who attend an educational institution in the GO Zone, and deduct personal casualty or theft losses caused by the hurricanes as a separate deduction from all other casualty losses along with many other tax benefits.

Also, taxpayers who provided housing for Hurricane Katrina-displaced individuals could claim an additional exemption, and cash contributions paid to qualified charitable organizations after August 27, 2005, were not subject to any limitations. This late legislation gave the IRS very little time to revise the necessary tax forms and computer programs before the start of the 2006 Filing Season. Overall, our review of these tax law changes for the 2006 Filing Season showed that the changes were implemented correctly.

19. To what extent do delays in issuing regulations or other guidance, or delays in deciding a legal position on an issue, impact the tax gap? Comment on the appropriate nexus between expedient tax administration and the "right" legal answer to a tax issue, e.g., is it preferable to issue guidance more quickly that meets the needs of 99% of taxpayers rather than deferring guidance for an extended time in

order to address the remaining 1% of taxpayers with unique or unusual circumstances?

We defer to the IRS on the advantages or disadvantages of delays in issuing guidance. However, in general, we would suggest that the IRS place a priority on issuing guidance that meets the needs of 99 percent of the taxpayers.

20. The National Taxpayer Advocate testified that examiners participating in the IRS's National Research Program reported that only 3% of the issues resulting in a change in tax liability were the result of "deliberate or intentional" acts, 27% of adjusted issues were identified as computational errors, and 67% were reported to be inadvertent mistakes.

a. To what extent are the examiners' figures reliable?
b. Dr. Mazur and Mr. Brostek commented that it was difficult to tell whether errors that studies had classified as simple mistakes were truly inadvertent. Please provide examples of studies that demonstrate this point.
c. What factors could influence an examiner's characterization of the causes of an adjustment to an issue?
d. What training do examiners receive to identify and characterize the causes of noncompliance?
e. For purposes of the NRP study, provide the definitions of deliberate, intentional, and inadvertent.
f. Please provide an example of the document completed by examiners that contains this information.
g. To what extent is an examiner required to consider penalties if he/she characterizes the cause of an adjustment to be the result of a deliberate or intentional act?

We defer to the IRS and the GAO because we have not evaluated this information and have no evidence gathered upon which to base an opinion.

21. Please provide a current list of all information returns that are matched to tax returns submitted to the IRS for the purpose of detecting unreported income. Identify additional information returns that will begin to be matched within the next 12 months.

According to the Internal Revenue Manual, the Automated Underreporter (AUR) system identifies income and expense discrepancies by matching information reported to IRS by taxpayers with information reported by third parties. Information documents submitted by payers include:

- *Form W-2, Wage and Tax Statement*
- *Form W-2C, Statement of Corrected Income and Tax Amounts.*

- *Form W-2G, Statement for Recipients of Certain Gambling Winnings.*
- *Form 1099-A, Acquisition or Abandonment of Secured Property*
- *Form 1099-B, Proceeds from Broker and Barter Exchange Transactions*
- *Form 1099-C, Cancellation of Debt*
- *Form 1099-DIV, Dividends and Distributions*
- *Form 1099-G, Certain Government Payments*
- *Form 1099-INT, Interest Income.*
- *Form 1099-LTC, Long Term Care and Accelerated Death Benefits*
- *Form 1099-MISC, Miscellaneous Income*
- *Form 1099-OID, Original Issue Discount*
- *Form 1099-PATR, Taxable Distributions Received from Cooperatives*
- *Form 1099-Q, Payments from Qualified Education Programs*
- *Form 1099-R, Total Distributions from Pensions, Annuities, Retirement or Profit-sharing Plans, IRAs, Insurance Contracts, etc. (Note: Form 1099-R should be attached if there is tax withheld.)*
- *Form RRB-1099, Payments by the Railroad Retirement Board.*
- *Form 1099-S, Proceeds from Real Estate Transactions*
- *Form 1099-SA, Distributions from an HSA, Archer MSA, or Medicare + Choice MSA*
- *Form SSA-1099, Social Security Benefits.*
- *Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, Etc.*
- *Schedule K-1 (Form 1065), Partner's Share of Income, Credits, Deductions, Etc.*
- *Schedule K-1 (Form 1120S), Shareholder's Share of Income Credits, Deductions, Etc.*
- *Form 1098, Mortgage Interest Statement*
- *Form 1098-E, Student Loan Interest Statement*
- *Form 1098-T, Student Tuition Statement*
- *Form 5498, Individual Retirement Arrangement Information*
- *Form 5498-ESA, Coverdell ESA Contribution Information*
- *Form 5498-SA, HSA, Archer MSA, or Medicare + Choice MSA Information*

The IRS AUR Program does not plan to match any new information returns in the next 12 months.

We have further information on the K-1 matching program. In two TIGTA reports, we discussed how the limitations on the IRS form Supplemental Income and Loss (Form 1040 Schedule E) would result in unnecessary notices to taxpayers and recommended certain changes be made to the Schedule E to improve the effectiveness of the Schedule K-1 matching program. The IRS made changes to the Schedule E and its instructions, asking taxpayers to separately identify offset amounts and identify the reasons for the offsets. However, IRS management states that it is limited in what changes can be made to the current Schedule E. In addition, issues relating to the burden caused by additional reporting

requirements for taxpayers and costs related to processing any additional information have to be weighed against the costs of manually screening these cases in the Underreporter function.

TIGTA recently issued another draft report to the IRS discussing how the IRS can further reduce the burden experienced by taxpayers receiving unnecessary notices questioning whether they included all of their income from Schedules K-1 on their individual income tax returns.

During the next fiscal year, TIGTA plans to look at mismatched names and Social Security Numbers on information return documents. The objective of this review will be to evaluate the progress underway to minimize mismatching names and Social Security Numbers (SSN) reported on Forms W-2 and Forms 1099 MISC, Miscellaneous Income.

22. The National Taxpayer Advocate, the GAO and others have recommended a basis reporting regime to reduce noncompliance resulting from incorrectly stated basis amounts.

- **Does the IRS have the ability to match basis amounts reported on an information return with basis amounts reported on a tax return?**
- **If the IRS lacks the ability to match basis information, provide the reasons why. Explain what actions are necessary to make such matching possible and how quickly this can be accomplished.**

We defer this response to the National Taxpayer Advocate and the GAO. We have not performed projects in this area and have no evidence to provide an opinion.

23. Dr. Mazur estimated that 7 million immigrants are on U.S. payrolls, and 75% of them pay employment taxes. Dr. Mazur indicated that the number of these individuals using stolen or false social security numbers is unknown.

We have not reviewed the source information for Dr. Mazur's estimate. We do note that Dr. Mazur refers to immigrants and does not differentiate between undocumented workers and aliens who are authorized to work in the United States. Our review entitled, "The Internal Revenue Service's Individual Taxpayer Identification Number Creates Significant Challenges for Tax Administration" identified the significant challenges that undocumented workers present for tax administration. We found unauthorized resident aliens had used approximately 265,000 SSNs that the Social Security Administration (SSA) had assigned to other individuals in Tax Year 2001. Under current law, the IRS is prohibited from sharing this information with the SSA.

- **IRS Publication 4535 advises individuals to respond immediately to an IRS notice in the event of a tax matter resulting from identity theft. Describe the actions taken by IRS officials when the IRS is notified by an individual that his/her identity has been stolen, resulting in a tax matter. Provide applicable Internal Revenue Manual sections or other internal guidance describing these procedures.**

We defer to the IRS to provide this information.

- **Describe the coordination between the IRS and TIGTA to determine the jurisdiction of stolen or fictitious identity cases that impact tax administration. Identify any impediments to such coordination, including IRC section 6103 disclosure issues.**

TIGTA receives some reports of stolen SSN information from the National Taxpayer Advocate's Office when that office becomes involved in adjusting a taxpayer's IRS account. For the most part, these complaints involve issues in which one taxpayer utilizes the SSN of another for wage reporting purposes, and this causes erroneous earnings to be posted to the innocent taxpayer's IRS account. This erroneous reporting causes the innocent taxpayer to contact the IRS to straighten out his or her wage earning records. In cases such as these, TIGTA relies on the Memorandum of Understanding with IRS Criminal Investigation to delineate the duties of each office as they pertain to substantive tax matters. Since the identity theft is based upon the filing of fictitious forms with the Secretary in conjunction with a substantive tax issue, in accordance with the MOU, TIGTA interprets this crime to fall within the program purview of the IRS. That said, TIGTA's investigations of identity theft primarily focus on indications of IRS employee involvement.

TIGTA's interest and jurisdiction in identity theft is focused on protecting taxpayer data entrusted to the IRS for tax administration purposes, and is accomplished through proactive and reactive investigative methods. TIGTA has investigative responsibility for the detection and investigation of unauthorized access of taxpayer information (UNAX) violations in accordance with the Taxpayer Browsing Protection Act of 1997 as well as any disclosures by IRS employees that are in violation of Section 6103. The term "UNAX" refers to the unauthorized access to taxpayer information and/or the disclosure thereof by IRS employees, as well as other Federal and State employees and private contractors.

Through the use of IRS Integrated Data Retrieval System (IDRS) audit trail reviews, TIGTA operates a UNAX detection program that proactively identifies IRS employees who exceed their authorized access to confidential taxpayer information. Cases of potential UNAX violations are investigated by TIGTA.

Employees found to have committed UNAX violations are subject to Federal prosecution, termination of employment, or other disciplinary action.

TIGTA's role in protecting the IRS and taxpayers from identity theft continues to emerge as factors change. For example, a recent collaborative venture between TIGTA and the IRS Computer Security Incident Response Center (CSIRC) was established as a result of the increased reporting of thefts of Government-owned computers. This TIGTA-initiated working group coordinates activities with the IRS CSIRC to reduce or eliminate any negative impact on tax administration. The cooperative effort includes a process to accurately report and document lost and/or stolen IRS Information Technology (IT) assets. TIGTA anticipates providing daily downloads to CSIRC informing the Center of any IT asset losses reported to TIGTA. This immediate notification to CSIRC should promote a swift response and possible preemptive measures to protect sensitive information.

Another example that illustrates TIGTA's dedication to protecting the confidentiality of taxpayer data involves the TIGTA Systems Intrusion and Network Attack Response Team (SINART). The SINART investigates individuals who attempt to hack into IRS data systems and also conducts proactive security assessments of IRS data systems to identify potential vulnerabilities that could be exploited by hackers.

Recently, TIGTA played a primary role in attempting to protect taxpayers from becoming victims of identity theft during the past filing season Internet phishing scams. Since November 2005, TIGTA investigations have identified phishing scams involving the IRS on 122 websites. Potential victims are sent emails purported to be from the IRS that asks them to click on a link to "access the IRS website" which links them to a site that requests personal information, such as their Social Security Numbers, that will be used for identity theft. As of August 20, 2006, TIGTA has received 12,000 complaints/inquiries about phishing scams. TIGTA is coordinating its investigative efforts with the Department of Homeland Security, the Federal Bureau of Investigations and the U.S. Computer Emergency Readiness Team.

The IRS and TIGTA's coordinated efforts to thwart phishing scams and minimize their impact on tax administration leverages the resources of both agencies. For example, TIGTA interacts with the IRS' new Identity Theft program office and the IRS has placed a link to TIGTA on its website for reporting of these scams.

- **How many stolen or fictitious SSN cases have been reported to the IRS during the last five years? How does the IRS track this figure?**

We defer to the IRS to provide this information.

- **How many stolen or fictitious SSN cases have been worked by the IRS during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.**

We defer to the IRS to provide this information.

- **How many stolen or fictitious SSN cases have been reported to TIGTA during the last five years? How does TIGTA track these cases?**

TIGTA does not categorize or track complaints specifically as "stolen or fictitious SSN" cases. As noted above, TIGTA's nexus to identity theft investigations is limited to the protection of willful unauthorized access, inspection, or disclosure of taxpayer information, including confidential taxpayer records contained in IRS computer databases as well as hard copies of tax returns. During the last five years, TIGTA has received 2,173 UNAX complaints.

TIGTA tracks case activity by way of a Performance and Results Information System (PARIS). PARIS is a computerized management information system that, among other things, provides TIGTA with the ability to manage and account for the thousands of complaints received and investigations initiated. The purpose of the PARIS is to properly document, account for, and track all investigations, including their results and the amount of time spent on investigations initiated by the TIGTA.

- **How many stolen or fictitious SSN cases have been worked by TIGTA during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.**

During the last five years, 2,703 investigations were conducted by TIGTA in which UNAX was an aspect of the allegation. Of the 2,703 investigations, 57 were prosecuted using UNAX/Disclosure-related statutes. These statutes include 18 U.S.C. § 1030, 18 U.S.C. § 1030(A)(2), 18 U.S.C. § 1030(A)(2)(B), 26 U.S.C. § 7213, and 26 U.S.C. § 7213A. Of the 57 cases prosecuted, 18 defendants were found guilty and eight were given pretrial diversion. The remaining cases are still pending prosecution.

- **In the event of a recurring problem, i.e., the same SSN is claimed by more than one taxpayer for more than one year, is the case worked every year or resolved for all future years?**

We defer the response to this question to the IRS.

- **Provide the Full Time Equivalents (FTEs) spent on ID theft cases during the last five years by the IRS and TIGTA.**

During the last five years, TIGTA spent a total of 143 Full Time Equivalents (FTE's) investigating UNAX cases.

- **To what extent do staffing levels impact on the IRS's, and TIGTA's, ability to work identify theft cases?**

The risk of confidential IRS data being compromised has intensified over the last few years due to the increased threat of identity theft and other abuses by IRS employees and others trying to obtain confidential taxpayer information. TIGTA's Office of Investigations currently has the capacity to focus monitoring on only one IRS system of records (IDRS) for potential UNAX violations by IRS employees. At current resource levels, approximately 1,200 potential UNAX leads go undeveloped. To compound the issue, pursuant to IRS modernization efforts, the IRS will be automating approximately 260 modernized systems of records containing confidential IRS employee and taxpayer information. TIGTA's proactive detection of potential UNAX violations have proven to have a substantiation rate of approximately 93 percent. TIGTA's current staffing levels are not sufficient to fully analyze and investigate either current or future employee misconduct and identity theft surfaced through its proactive UNAX monitoring. Based on the detection of approximately 500 UNAX cases over the past five years that resulted from the focus on one system (IDRS), it is believed that UNAX may become an increasingly critical concern facing the protection of taxpayer identity information.

24. Provide an analysis of the benefits and burdens on payers, payees, and the IRS, in connection with increased information reporting and withholding requirements. Include your conclusions and recommendations concerning an appropriate balance of benefits and burdens and the impact on effective tax administration.

We defer the response to this question to the IRS. We have performed reviews that evaluated the need to withhold on independent contractors; however, we did not assess the burden on payers, payees, and the IRS. TIGTA reported that from TY 1995 through TY 1998, the IRS received about 9.6 million information documents, reporting approximately $204 billion in non-employee compensation, which did not contain a Taxpayer Identification Number (TIN) or match the IRS' records of assigned TINs. Consequently, the IRS could not use these documents to verify that the taxpayers had filed tax returns and reported this income. Current tax laws and regulations enable the IRS to impose backup withholding requirements and assert civil penalties on payers, when applicable, to encourage

the submission of accurate information returns. However, these tools have been used sparingly and have been largely ineffective as evidenced by a 36 percent increase in the number of information documents received with missing or invalid TINs between 1995 and 1998. Tax law changes are needed to effect significant improvement in information reporting and to protect the substantial tax revenues that are potentially being lost each year.

From a payer burden perspective, recording transactions is part of the business process. With such substantial revenue at stake, we believe that there needs to be accurate information reporting to ensure that independent contractor income is properly reported. While there would be some burden in reporting these transactions, the IRS could facilitate receiving information documents by establishing an on-line system to allow TIN verification. We have not evaluated performing withholding at the source nor what would be a proper withholding rate.

We believe that whatever burden is incurred, there would be greater benefits to all taxpayers. The tax policy principle of horizontal equity suggests that similarly situated taxpayers be treated in a similar manner. So, there should not be significant policy differences between wage income, where there is full income reporting, and independent contractor income.

25. To what extent would raising public awareness of the importance of complying with tax laws impact the tax gap? Describe ways that raising public awareness could be achieved.

We defer the response to this question to the IRS. We are aware that raising the public awareness of the consequences of noncompliance is a strategy used by at least one State. California has included increasing publicity about the consequences of noncompliance in its budget proposal to reduce the tax gap in California.

We believe that the strategy used by California is a valid approach. To the extent that taxpayers are aware that the IRS audits and catches taxpayers who underreport income or fail to file tax returns, it acts as an incentive for others to comply. Raising public awareness can be achieved through the normal media channels the IRS currently employs. In addition, we believe that outreach programs to secondary schools and universities could affect future compliance.

26. The IRS website provides phone numbers and addresses for local IRS offices [3709 Lines]. Taxpayers are advised they can call a phone number, leave a message, and the call will be returned by the IRS within 2 business days. The Committee recently tested the level of service to taxpayers calling the IRS. Calls to 25 of these sites yielded only 18 returned phone calls, a 28% failure rate. Of the 18 responses, only one IRS caller suggested visiting the IRS website for information. The most

prevalent recommendation by the IRS responders was for the caller to visit the local IRS office for assistance. IRS leadership explains proposed reductions in taxpayer assistance center hours and services are justified because of increased web services.

- **Explain why 28% of the phone calls would not be returned.**

The results from our recent audit of the 3709 Line Program showed similar results. We reported that taxpayers cannot schedule appointments when calling the 3709 Lines. For 36 calls made to the 3709 Lines to schedule appointments to resolve a tax account issue, auditors were able to schedule only five appointments. (IRS procedures require appointments to be made for taxpayers with complex tax account issues, but not for those with tax law questions or requesting tax returns preparation.) In four instances, Taxpayer Assistance Center employees did not return the calls, and in 27 instances, Taxpayer Assistance Center employees returned the calls but would not schedule appointments.

Employees were not following IRS guidelines for returning telephone calls and scheduling appointments. In addition, internal guidelines are unclear and obsolete. The IRS has not updated its guidelines to reflect the current purpose of the 3709 Line Program. There are no criteria for Taxpayer Assistance Center employees to follow to determine if an appointment should be made for any tax account issue, or if an appointment can be made only for complex issues that cannot be resolved over the telephone.
Inconsistent and inaccurate information prevented us from determining the overall impact of the 3709 Line Program and how it relates to the overall goals of the Field Assistance Office. The Field Assistance Office does not maintain an overall list or database of the calls returned, or appointments scheduled through the 3709 Lines. IRS data is not accurate or complete.

- **Explain the apparent disconnect between IRS leadership and front-line employees regarding the use of the IRS website as an information resource for taxpayers.**

Our tests were intended to evaluate whether employees scheduled appointments. We did not evaluate whether employees discussed the IRS website as an information resource for taxpayers. However, during the 2006 Filing Season audit of the Taxpayer Assistance Centers, assistors did refer auditors posing as taxpayers to IRS.gov when assisting them with tax law questions. In addition, the 3709 Line message does refer taxpayers to IRS.gov.

Although IRS.gov offers self-assistance to determine the status of a tax refund, it does not offer individual taxpayers many account assistance options. It primarily offers only tax law assistance and return preparation. Therefore, if inquiring about an account issue, employees would not refer a taxpayer to IRS.gov.

27. TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," found that while the IRS has increased its examination coverage rate of high-income taxpayers, the increased coverage largely is due to correspondence examinations. TIGTA reported assessments of $1.4 billion on taxpayers who failed to respond to the IRS during correspondence exams, however, 71% of these assessments remained uncollected after almost 2 years. Given these results, is it efficient to use IRS resources to conduct a correspondence exam that can be ignored by a taxpayer without apparent consequence?

We agree that if a taxpayer can truly ignore the examination without consequence, it is not an efficient or effective use of resources. The IRS explained to us that it can reach more taxpayers at a lower cost through correspondence examinations than through more labor-intensive, face-to-face examinations. The IRS collects some of those assessments. Additionally, the IRS worked a backlog of high-income non-filer (HINF) cases, which affected the number of, and results from, high-income taxpayer cases.

According to the IRS, processing this backlog by correspondence examination allowed it to make contacts on cases that may not have been worked otherwise. Although many of the assessments on these cases have not yet been collected, IRS officials believe that establishing those assessments will enable it to pursue other compliance options, including criminal referrals, penalties, and other actions, such as filing a lien against the taxpayer that could result in some future payment. The IRS responded that it will continue to develop its plan to better identify high-income taxpayer returns for examination, including collection procedures. These procedures could encompass determining the collection potential of assessments and the priority of collection efforts assigned to various taxpayer segments.

28. TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," indicates that IRS management officials say they are working on a plan to better identify high-income tax returns for examination, *including placing less emphasis on non-filers.* TIGTA report #2004-30-127, "The Return Delinquency Notice Program Could Be Used More Effectively to Promote Filing Compliance and Reduce the Tax Gap," found that the number of potential individual non-filer cases increased from 6.1 million in 1994 to 8.9 million in 2001, but that IRS resources assigned to these cases had declined. TIGTA observed that the ability of the Return Delinquency Notice Program to effectively promote filing compliance has been significantly affected. TIGTA estimated at least $1 billion in taxes was foregone as a result.

a. Explain the IRS's decision to place less emphasis on high-income nonfilers in light of these TIGTA reports.

We have not reviewed the plan IRS is developing to better identify high-income taxpayers for examination, thus, we cannot comment on the appropriateness of de-emphasizing HINF cases.

b. What impact would deemphasizing high-income nonfilers have on tax administration and the tax gap?

Examination assessments on high-income taxpayer cases are significant. To the extent that these are accurate assessments and are collected, there would be a positive direct effect on reducing the net tax gap and likely a positive indirect effect on reducing the gross tax gap, both of which are good for tax administration. Conversely, de-emphasizing efforts on this taxpayer segment would adversely affect the tax gap and tax administration.

c. Why do so many high-income taxpayers ignore correspondence audits? Is this true for other taxpayer groups, as well?

We did not develop any audit evidence to determine the causes of taxpayer behavior. If we were to offer an opinion, several possible causes exist. One possible reason is that because it is a correspondence audit, the taxpayer is willing to take the risk that no other contact attempts will be made. Another possible reason is the taxpayer does not have sufficient money to pay the assessed taxes.

Assuming the second part of the question is not asking about reasons but simply whether other groups ignore correspondence audits, our preliminary research indicates that for all individual taxpayers, the percentages of examinations closed by correspondence in which there was no response increased from 22 percent to 31 percent from FY 2002 through mid-FY 2006. From a revenue perspective, no-response cases accounted for 18 percent of correspondence examination assessments in FY 2002, and this increased to 45 percent of correspondence examination assessments through mid-year FY 2006. We have initiated an audit to review examinations closed with no taxpayer response.

To gain a historical perspective, we also analyzed the no-response rate for correspondence audits for Fiscal Years of 1997, 1998 and 1999. We found the average no-response rate for those years to be 51 percent.

d. What can the IRS do to increase taxpayer response to correspondence audits?

We believe at least one action could improve the no-response rate. The IRS needs to ensure that procedures are followed that establish whether taxpayers can be located and contacted before initiating examinations and whether there are any indicators that an examination assessment might be uncollectible, as taxpayers in those circumstances may have less concern about not responding to IRS inquiries.

In addition, the effectiveness of correspondence audits needs to be further assessed. It is probable that these types of examinations are ineffective for certain types of taxpayers, which may include high-income non-filers. At the same time, severe penalties and aggressive enforcement actions may be options to increase the response rate.

e. How can the IRS collect tax deficiencies resulting from correspondence audits sooner?

The IRS could perform research on why correspondence examination deficiencies remain uncollected. It could increase the priority of such cases in its collection stream if the research shows that such a change would be worthwhile.

29. TIGTA report #2006-40-067, "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program," found that at least 47 Taxpayer Assistance Centers are understaffed. What plans does the IRS have to ensure that TACs are staffed commensurately with taxpayer needs?

Staffing was a challenge during the 2006 Filing Season. Not all TACs were fully staffed, and not all TACs provided standard services or standard hours of operation, from 8:30 a.m. to 4:30 p.m., Monday through Friday. The IRS advised us that it took actions to minimize the staffing impact and ensure that all 400 TACs remain open as required by the law. In January 2006, the IRS completed critical hiring of 54 frontline technical employees, returned all seasonal employees, detailed former TAC employees from other IRS organizations, and had some employees travel between TACs to ensure all TACs remained open daily.

From the May 2006 Wage and Investment (W&I) Business Performance Review, the IRS reported that the Field Assistance Office had begun another round of critical attrition hiring. Authority to hire 141 Taxpayer Resolution Representatives (TRR) was granted, and these new hires should have been on board by June 30, 2006. The Field Assistance Office is also attempting to hire an additional 52 other critical positions.

30. The May 27, 2006 IRS Filing Season Data reports 3,449,641 field assistance walk-in contacts, an 11.1% decrease from 2005. Describe

how this count is taken. Are taxpayers who desire services not offered by the TAC included? Are taxpayers who appear outside the hours of service or when the TAC is closed for lunch counted?

The IRS counts only those taxpayers who are served by an assistor. According to the Wage and Investment Division's Data Dictionary, the total number of contacts is: "The total number of customers assisted, including the number of customers assisted with tax return preparation, in Taxpayer Assistance Centers. All face-to-face, telephone, and correspondence contacts are included."

The count is calculated by taking the total number of units recorded daily on a Taxpayer Assistance Center employee's time card. This figure is the sum of Total Walk-In Units (including Customers with Forms, Total Returns prepared, Tax Law Questions, Account Work/Notices, and Other Field Assistance Contacts), Customer Incoming Telephone Calls, and Correspondence answered in Taxpayer Assistance Centers. A "unit" represents a customer assisted. One unit is recorded for each customer assisted.

Therefore, those taxpayers turned away or who leave (either at the door, or before or after they take a number to be served) are not counted. However, if a taxpayer speaks with an assistor, the IRS records it as a contact, even if that taxpayer's question is beyond the services offered at the TACs. For example, if the taxpayer asks questions about small business taxes, the assistor will not be able to respond but will instead refer the taxpayer to another IRS source. However, this will count as a contact.

In addition, the IRS does not include in the total contacts the number of taxpayers who visit the Taxpayer Assistance Centers to obtain tax forms and publications. Many of the Taxpayer Assistance Centers have these documents available by self-help. They would not be counted if all they did was take a form or publication off the shelf.

31. Provide estimates of the average return on investment (ROI) for each additional dollar appropriated to the IRS for enforcement (relative to the FY 2006 appropriation). Please include both the direct and indirect effects on revenues. Indirect effects should include both the impact on taxpayers whose returns or parts of returns are not examined, and the impact in subsequent years on taxpayers whose returns or parts of returns are examined.

We defer response to this question to the IRS because we have not performed an analysis to estimate the ROI for each additional dollar of enforcement. We have reviewed the studies concerning the direct and indirect effects of enforcement; however, this has not been applied to the FY 2006 appropriation.

32. Provide estimates of the average return on investment (ROI) for each additional dollar appropriated to the IRS for taxpayer service (relative to the FY 2006 appropriation). Please include both the direct and indirect effects on revenues. Indirect effects should include both the impact (if any) on taxpayers not receiving service and the impact in subsequent years on taxpayers who receive service.

We are not aware of any IRS management information system that would have sufficient data to make these determinations. There is no data available at this time to calculate the direct or indirect effect of customer service on compliance or revenues.

Note: The IRS could take the customer service appropriations and calculate the cost of customer service per contact. However, this would not be a clear indicator of the cost since the IRS does not capture all taxpayer contacts.

33. Provide estimates of the average return on investment (ROI) for each additional dollar appropriated to the IRS for any purpose (relative to the FY 2006 appropriation). Please include both the direct and indirect effects on revenues. Indirect effects should include both the impact on taxpayers whose returns or parts of returns are not examined or who do not receive service, and the impact in subsequent years on taxpayers whose returns or parts of returns are examined or who do receive service.

We defer response to this question to the IRS because we have not performed an analysis to estimate the ROI for each additional dollar of enforcement. We have reviewed the studies concerning the direct and indirect effects of enforcement; however, this has not been applied to the FY 2006 appropriation.

34. To what extent is it feasible for the IRS to include a "marker" on its Master File system to denote that a Form 8886 has been filed?

We defer this question to the IRS. We believe that with the information contained on the form, an indicator could be taken from the return and included on the Master File. We have no estimate of the time or cost required to implement the change.

35. TIGTA report #2006-50-077, "Some Concerns Remain about the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections," found that assumptions and methodologies used by the IRS to calculate the 2001 tax gap may be faulty. To what extent is the reliability of the IRS's estimates of the tax gap compromised by faulty assumptions and methodologies?

The results and parameters of any economic model are subject to error and change. We did not develop an estimate on the effect of the problems the IRS has with updating very dated estimates in the various tax gap components. However, since considerable time has elapsed since they were developed, the assumptions used with those estimates require analysis. Since there is missing and aged data, there should be an investigation of the effect of changes or errors on the tax gap model.

Sensitivity analysis is the investigation of these potential changes and errors, and their impacts on conclusions to be drawn from the model. Each variable and assumption that has an impact on the overall outcome would be evaluated individually and in combination to determine the impact. The IRS personnel with knowledge of the tax gap map stated that a sensitivity analysis was not performed.

36. For FY 2005, please provide the following data about the IRS's Automated Collection System (ACS). TDA refers to Taxpayer Delinquent Accounts and TDI refers to Taxpayer Delinquency Investigations.

a. Number of TDAs closed during the year, and length of time in inventory

During FY 2005, the IRS ACS function closed approximately 3,052,010 TDA modules for approximately 1,468,314 taxpayers. This does not include 211,292 TDA modules for 122,631 taxpayers whose accounts were shelved. These TDAs were in the ACS inventory an average of 33 weeks. Source: Trends in Compliance Activities Through Fiscal Year 2005, (Reference Number: 2006-30-055, dated March 2006) and IRS Collections Report 5000-2.

b. Number of TDAs in inventory at the end of the year, and average length of time in inventory

At the end of FY 2005, the IRS ACS function had approximately 3,480,010 TDA modules for 1,790,472 taxpayers in inventory. The TDAs were in ACS inventory an average of approximately 36 weeks.

Age of TDA Inventory	*Number of Modules*
Less than 6 Months	*1,996,093*
6 Months to 9 Months	*328,918*
10 Months to 15 Months	*606,978*
16 Months and Over	*548,021*
Total Modules at Year End	*3,480,010*

Source: IRS Collections Report 5000-2

c. Number of TDIs closed during the year, and length of time in inventory

During FY 2005, the IRS ACS function closed approximately 582,619 TDIs with 931,414 modules (tax periods). The TDIs were in ACS inventory an average of 30 cycles (weeks). (Source: IRS Collections Report 5000-4.)

d. Number of TDIs in inventory at the end of the year, and average length of time in inventory

At the end of FY 2005, the IRS ACS function had approximately 1,223,025 TDIs in inventory with 2,823,883 tax modules. The IRS Collection Report does not provide the necessary data to calculate an average length of time in inventory. However, the report does provide a breakdown of the age in inventory. The IRS data showed the following age in inventory for the ACS function at the end of FY 2005:

Age in Inventory	*TDIs*	*Modules*
Less than 6 Months	*813,292*	*2,153,454*
6 Months to 9 Months	*86,415*	*117,915*
10 Months to 15 Months	*209,832*	*343,275*
16 Months & Over	*113,486*	*209,239*
Total	*1,223,025*	*2,823,883*

Source: IRS Collections Report 5000-4

e. Total collections, collections per case, collections per FTE

During FY 2005, the IRS ACS function collected approximately $1.94 billion for an average collection per case (e.g., taxpayer disposition) of approximately $1,322. We do not have the information readily available to calculate the collections per FTE.

f. Accounts written off, average length of time in inventory, dollar value of the accounts written off, and criteria used to decide whether to write-off

During FY 2005, the IRS ACS function wrote off 75,097 tax modules due to expired statutes (e.g., CSED) totaling approximately $256.7 million. The IRS collection information on the amount of time in the ACS inventory was not readily available. In addition to amounts actually written off, the IRS declared 742,080 modules as currently not collectible totaling over $2.5 billion. With the exception of accounts shelved, information on the amount of time in the ACS inventory was not readily available. The breakdown of accounts declared as currently not collectible is as follows:

Currently Not Collectible Reason	***Tax Modules***	***Dollar Amount***	***Average Weeks in Inventory***
Accounts Shelved	*211,292*	*$397,987,798*	*85.1*
Unable to Locate or Unable to Contact	*302,287*	*945,747,200*	*Not available*
Bankruptcy or Defunct Corporation	*1,276*	*5,584,413*	*Not available*
Hardship	*188,905*	*893,623,946*	*Not available*
Other CNC	*38,320*	*269,455,098*	*Not available*
Total	*742,080*	*$2,512,398,455*	

Source: IRS Collections Report 5000-2

g. Number of incoming phone calls and the number of calls answered

In FY 2005, the ACS received 5.1 million phone calls attempts. The ACS answered 3.8 million calls (approximately 122,000 of these calls were answered by an automated system). Approximately 1.3 million calls were abandoned before the taxpayer spoke with a Customer Service Representative.

h. Number of outgoing calls

We defer to the IRS to provide the statistics for this inquiry.

i. To what extent do staffing levels and technological capacity impact the ability to process calls and work the accounts?

Historically, staffing levels have an impact on ACS performance. In a relevant report issued in 2000, we observed that the ACS staffing declined by more than 20 percent from FY 1997 to FY 1999. During this same period, the ACS' delinquent accounts inventory grew by 26 percent and the number of delinquent

accounts assigned to the Queue increased by 21 percent. Other issues that impacted the IRS' ability to work the accounts included:

- *Reassignment of ACS employees to customer service duties during the filing season; and*
- *Implementation of the IRS Restructuring and Reform Act of 1998 (RRA 98), with its emphasis on taxpayer rights protections.*

For additional information, see TIGTA report entitled, "Management Advisory Report: Actions to Improve the Automated Collection System Should Be Taken Within a Sound Strategic Framework" (Reference Number: 2000-30-122, dated August 2000).

Technological capacity also has an impact on ACS performance. In a relevant report issued in 2004, we observed that the IRS launched a series of programs to modernize its technologies and processes to address many collection enforcement challenges, one of which is the Filing and Payment Compliance (F&PC) project. Projected capabilities of the F&PC project include increased and timely use of third-party data in case detection and case resolution; decision analytics for risk-based scoring, customer segmentation, and treatment assignments; and improved treatment streams (a series of tailored consecutive collection actions). Decision analytics is a software application that builds scoring models to identify segments or groupings of receivables and predicts collectibility; it designs treatment streams aimed at efficiently collecting the receivables the models identify.

Although the F&PC project is estimated to result in $27 billion in additional tax revenues through FY 2016, it is a long-term solution dependent on the IRS' historically problematic modernization efforts. Funding has not been consistently provided, and the F&PC project is not likely to enhance the collection process for some time, leaving the IRS operating divisions to develop their own short-term improvements. The Risk-Based Collection (RBC) initiative was the Small Business/Self-Employed (SB/SE) Division's solution. For more information see TIGTA report entitled, "The New Risk-Based Collection Initiative Has the Potential to Increase Revenue and Improve Future Collection Design Enhancements" (Reference Number: 2004-30-165, dated September 2004).

j. Number of cases in the Collection Queue, average length of time in inventory, and the dollar value in the queue

The Queue is an automated holding file for unassigned inventory. Inventory is placed in the Queue until it can be assigned as workload for Collection function employees or shelved due to lack of resources.

At the end of FY 2005, the IRS Queue had approximately 2,023,346 Taxpayer Delinquent Account (TDA) modules in inventory for 607,114 taxpayers totaling

approximately $20.3 billion. The TDAs were in the Queue inventory an average of approximately 81 weeks. (Source: IRS Collections Report 5000-2.)

k. Queue accounts written off, average length of time in inventory, dollar value of the accounts written off, and criteria used to decide whether to write-off

During FY 2005, the IRS wrote off approximately 74,769 tax modules due to expired statutes (e.g., CSED) totaling approximately $704.3 million for accounts that were in the Queue inventory. The IRS collection information on the amount of time in the Queue was not readily available. In addition to amounts actually written off, the IRS declared 592,225 modules as currently not collectible totaling over $2.9 billion. With the exception of accounts shelved, information on the amount of time in the Queue inventory was not readily available. The breakdown of accounts in the Queue declared as currently not collectible is as follows:

Currently Not Collectible Reason	***Tax Modules***	***Dollar Amount***	***Average Weeks in Queue Inventory***
Accounts Shelved	*574,912*	*$2,682,701,232*	*61.13*
Unable to Locate or Unable to Contact	*1,036*	*22,751,630*	*Not available*
Bankruptcy or Defunct Corporation	*2,700*	*48,652,896*	*Not available*
Hardship	*11,887*	*152,857,421*	*Not available*
Other CNC	*1,690*	*31,991,947*	*Not available*
Total	*592,225*	*$2,938,955,126*	

Source: IRS Collections Report 5000-2

l. To what extent will the private debt collectors be assigned inventory from ACS and the Queue?

Cases are to be selected from two IRS inventories of unassigned cases. The first is the Queue, which is the inventory from which the IRS selects cases to be assigned to field Collection function employees. The second inventory is made up of cases that have been "shelved" (those that have been removed from the Queue because they are lower priority cases). The criteria for selecting Private Debt Collection (PDC) program cases include a factor for the age in status but do not account for the age of the balance due. For example, the criterion for Shelved cases was fewer than six months in that status. However, many Shelved cases have been in some prior status for a number of months.

In analyzing IRS reports, we determined that 77 percent of the Shelved cases had a tax delinquency (date from assessment) more than two years old. In

addition, 45 percent of the cases to be assigned from the Queue were more than two years old. Overall, approximately 72 percent of the cases available for placement in the PDC program were more than two years old.

The IRS is considering revising the selection criteria to obtain additional cases for placement. One revision being considered will increase the age threshold to two years in status. The current criteria are fewer than six months in status for Shelved cases and between 60 days and one year for Queue cases. The revision being considered will increase the balance-due age of the cases included in the PDC program even further. For more information see TIGTA Report entitled, "Management Needs to Continue Monitoring Some Case Selection Issues As the Private Debt Collection Program Is Implemented" (Reference Number 2006-30-064, dated April 2006).

Senator Kerry

1. What concrete steps should be taken to improve voluntary compliance?

TIGTA has not performed audits or evaluations on steps that can be taken to improve voluntary compliance. We have identified some causes of the tax gap. If these causes are addressed, we believe that voluntary compliance would improve.

Tax Law Complexity –

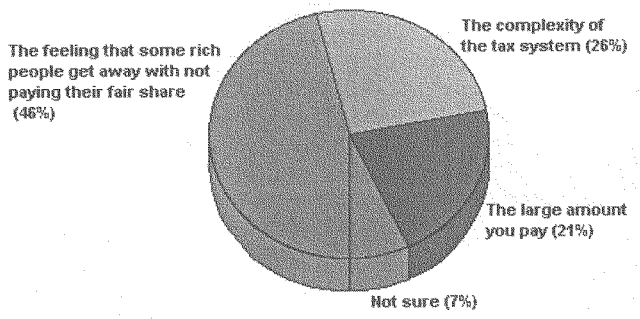
Whether complexity itself causes the tax gap because of confusion or whether complexity increases avoidance/evasion and leads to higher costs to comply, tax law complexity is seen as a major contributor to the tax gap.

Perception of fairness –

The non-partisan organization Public Opinion reported on a survey that more taxpayers are bothered that the rich may not be paying their fair share than any other concerns about the tax system.

Many Americans say when it comes to taxes they are most bothered by the feeling that some rich people get away without paying their fair share

Which of the following bothers you most about taxes: the large amount you pay in taxes, the complexity of the tax system, or the feeling that some rich people get away with not paying their fair share?



Source: Fox News / Opinion Dynamics 3/99

The perception of fairness cause is the view that corporations and rich individuals have loopholes that allow them to not pay taxes. So, taxpayers may be inclined to devise their own methods to avoid or evade taxes.

Increased Cost of Social Taxes –

Economists who study the shadow economy globally identify that the costs of social taxes cause businesses to avoid or evade taxes. There is also increasing evidence that the increased costs of social taxes cause employers to hire "independent contractors" who may be undocumented workers or to simply pay employees "under the table." Studies by economists on the shadow economies all over the world attribute tax evasion to the additional costs of social taxes.

Cost of Compliance –

The cost of compliance is linked with the increased cost of social taxes by the same economists. Beyond this, the non-partisan Tax Foundation found that the cost of compliance by small businesses is 27 times greater as a percentage of assets when compared with the largest firms.

The Use of Tax Havens to Avoid Taxation –

In August 2006, the Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations issued a report entitled, "Tax Haven Abuses: The Enablers, The Tools, and Secrecy." The report recommended that Congress empower the Treasury Department to eliminate tax benefits in havens that do not cooperate with U.S. authorities. Americans have

an estimated $1 trillion offshore in about 50 havens — including Belize, the British Virgin Islands, the Cayman Islands, the Isle of Man, Nevis, and Panama — that impose little or no taxes on non-residents. The estimate is that U.S. taxpayers avoided approximately $40 billion a year in taxes through tax havens.

2. Is the underreporting of income the biggest contributor to the tax gap and if so, are there ways to significantly improve reporting that are not burdensome and costly for small businesses?

We defer to the IRS to provide the response to this question. However, we would add that according to the IRS tax gap map, underreporting of income is the largest contributor to the tax gap. Increased reporting by definition increases taxpayer burden, since it increases the time and costs to comply with the tax laws.

We believe that it is very important for the IRS to ensure small business tax compliance. Small businesses that avoid or evade taxes are at a competitive advantage over their competition. For example, a business that does not properly pay employment taxes has a large labor cost advantage over a business that does pay employment taxes.

So, we believe that there are methods to increase compliance such as previous recommendations made by an IRS study. The study contained many recommendations that addressed both increased information reporting and increased withholding. In addition, the study recommended that businesses and licensed professionals obtain a certificate of the filing and payment of taxes in order to operate.

3. In a new report, the Treasury Inspector General for Tax Administration has criticized lapses in IRS security measures to protect against unauthorized access to returns. What is being done to address this?

Background *– The Integrated Data Retrieval System (IDRS) is a mission critical system containing sensitive information such as taxpayers' names, Social Security Numbers, birth dates, addresses, filing statuses, exemptions, and income. This System is used by IRS employees to research and update taxpayer data. Because of the sensitive nature of its data, the IDRS routinely generates audit trail[1] information. In 2002, the IRS incrementally deployed the IDRS Online Reports Services (IORS) system[2] to reduce the costs of printing and distributing paper reports of IDRS audit trail information to IRS personnel responsible for identifying unauthorized accesses. However, audit trail information from the IORS system was not always being reviewed and*

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[1] An audit trail is a chronological record of system activities that allows for the reconstruction, review, and examination of a transaction from inception to final results.

[2] The IORS system is a web-based application that provides business unit managers and data security staffs online access to security reports based on the IDRS audit trail information.

investigated to detect unauthorized accesses and noncompliance with security controls. Our review found that a majority (58 percent) of business unit managers are not performing their responsibilities to investigate potential unauthorized accesses to IDRS accounts and noncompliance with security controls. As a result, employees may be browsing their spouses' or other employees' tax information with little chance of detection.

***To address the 58 percent non-compliance rate for reviewing security reports** – The IRS' Mission Assurance and Security Services (MA&SS) organization is implementing a semiannual monitoring and reporting process that will determine the compliance rates of IRS business units. IRS business units will be advised of their compliance. In addition, all IRS business unit reviews will require operational reviews that monitor and track all IRS managers' compliance with security reports. If managers fail to review their required security-related reports, the IRS will enforce consequences for non-compliance.*

***To address the limitations of the IDRS Online Reports Services (IORS) system** – The IRS' MA&SS organization is coordinating with the Chief Information Officer to assume the responsibility of obtaining the technical contract for the IORS system. The MA&SS organization IDRS Security Program Office will prioritize the systemic weaknesses of the IORS system and monitor the process for timely implementation of systemic changes.*

4. What percent and amount of the tax gap can be contributed to the earned income tax credit (EITC)? What percent of audits is conducted on EITC filers?

We defer to the IRS for response to this question. From the initial IRS tax gap map for 2001, the IRS estimated that EITC accounted for $8.9 billion of the estimated tax gap. If this amount is used with the revised tax gap estimate of $345 billion, EITC would account for about 2.6 percent of the tax gap.

However, the most current official non-compliance rates for EITC are for TY 1999 returns showing approximately 30 percent of the $31.3 billion claimed in EITC was erroneous, or approximately $9.4 billion that should not have been paid. Equating this to the estimated tax gap of $345 billion, EITC would make up approximately 2.7 percent. By either calculation, the EITC component is consistent.

EITC audits accounted for about 37 percent (449,664 of 1,215,308) of all individual audits in FY 2005. However, EITC audits made up about 45 percent of audits of returns with income under $100,000 (449,664 of 996,100).

The reasons for EITC non-compliance include, among others, claiming children in error, underreporting income, and using the wrong filing status. The latest Proof of Concept results we have, which were reported in October 2005

(certification actions through late May 2005), show that about 83 percent of the AUR notices that were sent out (216,049 of 260,300) resulted in a reduction or disallowance of the EITC claimed. Certification also seems to have a significant impact on reducing the number of improper EITC claims. However, the report does not provide the number of returns in which EITC was adjusted during certification. It does show that the amount of EITC paid out was reduced by the certification process and the number of returns that claimed children incorrectly was reduced because of the certification process.

5. In a new report, the Treasury Inspector General for Tax Administration indicates that 70 percent of the assessments on high-income taxpayers have not been collected. Why has this happened and what can be done to improve collection rates?

If a taxpayer can truly ignore the examination without consequence, obviously it is not an efficient or effective use of resources. The IRS explained to us that it can reach more taxpayers at a lower cost through correspondence examinations than through more labor-intensive, face-to-face examinations. The IRS collects some of those assessments. Additionally, the IRS worked a backlog of high-income non-filer (HINF) cases, which affected the number of, and results from, high-income taxpayer cases.

According to the IRS, processing this backlog by correspondence examination allowed it to make contacts on cases that may not have been worked otherwise. Although many of the assessments on these cases have not yet been collected, IRS officials believe that establishing those assessments will enable it to pursue other compliance options, including criminal referrals, penalties, and other actions, such as filing a lien against the taxpayer that could result in some future payment. The IRS responded that it will continue to develop its plan to better identify high-income taxpayer returns for examination, including collection procedures. These procedures could encompass determining the collection potential of assessments and the priority of collection efforts assigned to various taxpayer segments.

The no-response trend is not new. The average no-response rate for FY 1997, FY 1998 and FY 1999 was 51 percent. We believe at least one action could improve the no-response rate. The IRS needs to ensure that procedures are followed that establish whether taxpayers can be located and contacted before initiating examinations and whether there are any indicators that an examination assessment might be uncollectible, as taxpayers in those circumstances may have less concern about not responding to IRS inquiries.

In addition, the effectiveness of correspondence audits needs to be further assessed. It is probable that these types of examinations are ineffective for certain types of taxpayers, which may include high-income non-filers. At the

same time, severe penalties and aggressive enforcement actions may be options to increase the response rate.

6. What percent of audits are conducted on high-income taxpayers?

Examinations of high-income taxpayers comprised 18 percent of all individual taxpayer examinations in FY 2005. Examination coverage of all high-income taxpayer returns in FY 2005 was 1.57 percent (.84 percent for non-business returns, 3.65 percent for Schedule C business returns, and 1.01 percent for Schedule F business returns).

Statement of Senator Jeffords
"A Closer Look at the Size and Sources of the Tax Gap"
Subcommittee on Taxation and IRS Oversight
Senate Finance Committee
July 26, 2006

Chairman Kyl, I want to commend you for holding today's hearing on the tax gap. I also want to recognize the efforts of Chairman Grassley, and especially Senator Baucus, in calling attention to this issue over the years.

Even more important than talking about the problem, of course, is taking action to fix it. I look forward with great interest to the plan of action we will be receiving from the Administration in the next few months.

I have to say I am not sure this has been a high enough priority for the Administration. When I checked last week we were still awaiting answers from the Administration to questions posed at our April 2005 hearing on the tax gap.

Congress bears plenty of the responsibility as well. We have had lots of good recommendations for years from several sources, including many of today's witnesses, but have yet to act on them.

I hope that with our continued efforts to shed light on this problem we can build support for taking concrete steps to attack it. As Ms. Olson pointed out last year, the average tax return includes a tax gap "surtax" of $2,000 each year. We need to get that number as close to zero as we possibly can.

Mr. Chairman, thank you again for calling today's hearing, and my thanks as well to the witnesses for their willingness to help us, and their work day-in and day-out on this vital issue.

Opening Statement of Senator Kyl, Chairman
Subcommittee on Taxation and IRS Oversight, Senate Finance Committee
At the July 26, 2006 Hearing
"A Closer Look at the Size and Source of the Tax Gap"

The full Finance Committee held a hearing in 2005 on the tax gap, that is, the difference between what the U.S. taxpayers owe and what the U.S. Treasury actually receives. The Budget Committee held a similar hearing earlier this year. Today's hearing is designed as a follow-on to those hearings and will take a much closer look at the tax gap. We will consider its size, and what causes it to exist.

Chairman Grassley and Senator Baucus have asked the Treasury Department and the Internal Revenue Service to develop a strategy for addressing the tax gap. If members of this committee are going to evaluate any such strategy, I believe we need to have a more comprehensive understanding of the problem. And that is the purpose of this hearing – to give Senators on the Finance Committee an opportunity to learn more about the tax gap so that we can make better decisions when we are presented with legislative proposals designed to improve tax compliance.

Like revenue estimates produced by other government number crunchers, the tax gap is an estimate. But if Congress is going to push the IRS to reach a voluntary taxpayer compliance target, we need to know how good the estimate is and we need an understanding of where it could and should be improved. We also need to understand what data might be too difficult to collect without imposing unreasonable burdens on taxpayers.

In addition to understanding the numbers, we also need to consider where the current system is failing, what can be done to address those failures, and how efforts to improve tax compliance will affect taxpayers. In preparing for this hearing, we asked the witnesses to consider where current IRS enforcement practices are falling short and whether additional resources would improve compliance enough to justify the expense. We asked whether current enforcement tools are sufficient, or if additional tools, such as

increased information-reporting or withholding, would be appropriate. Finally, we asked the witnesses to consider the extent to which the tax system itself – with its mind-boggling complexity and special targeted tax benefits – contributes to the tax gap.

This last point – the need for tax simplification – may be the most reasonable way to address the tax gap. I know the Chairman of this Committee is pressing forward on tax reform and I expect that simplifying our tax system and improving compliance will be critical to that effort. Most Americans are responsible, honest, and hard-working, and we should not assume they are falling short in their tax obligations on purpose. A more simple and straightforward tax system will reduce compliance costs and make it easier for Americans to pay the taxes they owe.

WRITTEN TESTIMONY OF
MARK J. MAZUR
DIRECTOR, RESEARCH, ANALYSIS, AND STATISTICS
BEFORE
THE SENATE COMMITTEE ON FINANCE'S
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
ON
THE TAX GAP
JULY 26, 2006

Introduction

Chairman Kyl, Senator Jeffords, and Members of the Subcommittee, I am pleased to be here today to discuss the latest information we have on the tax gap. My name is Mark Mazur and I am the Director of Research, Analysis, and Statistics within the Internal Revenue Service. Because my office is not directly involved in either direct service to taxpayers or in direct compliance efforts, my remarks today will focus on the tax gap numbers themselves as well as the methodology we used to arrive at those numbers. I also would like to discuss the direction of future studies related to the tax gap.

Background:

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.

Commissioner Everson has stated repeatedly 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.

History of Estimating the Tax Gap

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, all of our subsequent estimates of the tax gap have been rough projections that basically assume 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 was born out of the desire to find a less intrusive means of measuring tax compliance. We used a focused statistical selection process that resulted in the selection of approximately 46,000 returns, somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time.

Like the compliance studies of the past, the NRP was designed to allow 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.

The first NRP innovation was to compile a comprehensive set of data to supplement what was reported on the selected returns. The sources of the "case building" data included third-party information returns from payers of income (e.g., Forms W-2 and 1099) and prior-year returns filed by the taxpayers. Also, for the first time we added data on dependents from various government sources, as well as data from public records (e.g., current and prior addresses, real estate holdings, business registrations, and involvement with corporations). Together, these data reduced the need to ask taxpayers for information, with some of the selected taxpayers not needing to be contacted at all by the IRS. In effect, these data allowed us to focus our efforts where the return information could not otherwise be verified. This pioneering approach was so successful it is being expanded into our regular operational audit programs.

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

Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders (including representatives of tax professional associations) in the design and implementation of the study. As mentioned earlier, the more focused selection process resulted in the NRP

sample including around 46,000 returns—somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time. Clearly, the NRP approach was much less burdensome on taxpayers than the old TCMP audits, which examined every line item on every return. At the same time, the data collected through the NRP reporting compliance studies is about the same quality as that collected under TCMP.

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).

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). For example, the tax gap does not include the illegal sector of the economy, which makes up a significant portion of the underground economy. Moreover, 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, that are characteristic 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, at this point, we do not have sufficiently good data to clearly distinguish the amount of non-compliance that arises from willfulness, as opposed to unintentional mistakes. This is an area where we expect future research to improve our understanding.

Latest Numbers

The results of the NRP individual income tax reporting compliance study were rolled into our overall tax gap estimates and show that there is an overall gross tax gap of approximately $345 billion, corresponding to a noncompliance rate of 16.3 percent. The net tax gap or what is remaining after enforcement and other late payments is about $290 billion.

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 tax gap estimates for each of these three types of noncompliance.

Underreporting constitutes nearly 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. While a comparison with 1988 data would suggest a slight worsening of individual income tax reporting compliance, it is important to remember that the data tell us nothing about the years just before or just after Tax Year 2001 and, as such, cannot tell us whether compliance trends today are improving or getting worse. Moreover, many things are not comparable about the data and estimating methodologies used now relative to earlier studies.

As in previous compliance studies, 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) 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, deductions, and exemptions) and from overstated tax credits.

NRP-Based Tax Gap Estimates, Tax Year 2001

Tax Gap Component	*Gross Tax Gap ($ billions)*	*Share of Total Gap*
Individual income tax underreporting gap	**197**	**56%**
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%**
All other components of the tax gap	**109**	**33%**
Total Tax Gap	**345**	
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, then, we see that individual underreporting contributes approximately two-thirds of the overall tax gap.

It appears that compliance rates for sections of the Form 1040 where the most noncompliance occurs have not changed dramatically since the last compliance study for Tax Year 1988. 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. 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 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.

With transactions that are less "visible" to the IRS, and with very low audit rates by historical standards, some sole proprietors may have become emboldened to cut corners on their taxes. Other small business owners may be swamped by the cost and complexity of meeting their tax obligations and their business requirements. Whatever the reason, it is easy to see that we have a serious problem with underreporting for those items not subject to withholding or third party information reporting.

Latest NRP Study

In viewing the strategic value of monitoring compliance trends, we now recognize the need to conduct reporting compliance studies more regularly. Each study will address a component of the overall tax gap. By measuring compliance for various types of taxes and taxpayers, we will be better able to target resources to encourage compliance, deter non-compliance and reduce the burden on taxpayers.

The most recent NRP reporting compliance study focuses on S corporations. Since 1985, S corporation return filings have increased dramatically. In that year there were 722,444 Form 1120 S returns filed. In 2002 that number had grown by four times to over 3.1 million. Compare that to other corporate returns which declined by approximately 450,000 over the same period.

By 1997, S corporations became the most common corporate entity. In 2003, nearly 3.4 million S corporations filed tax returns, accounting for over 58 percent of all corporate returns filed that year. The last time we conducted an S corporation study was 1984. As a result, we do not have reliable reporting compliance data for these entities.

The current NRP study of reporting compliance involves approximately 5,000 Form 1120S returns from a nationwide random sample. We used the asset size of the S corporation in the return selection process. This reporting compliance study involves Tax Years 2003 and 2004. This is the first time the IRS has conducted a reporting compliance study across tax years and it will require us to knit the data together to give a

comprehensive picture. This study is underway and we expect it to continue through 2007.

Conclusion

On the whole, Mr. Chairman, our system of self-assessment of tax liabilities works well. Most countries would be thrilled to have a voluntary compliance rate of almost 84 percent.

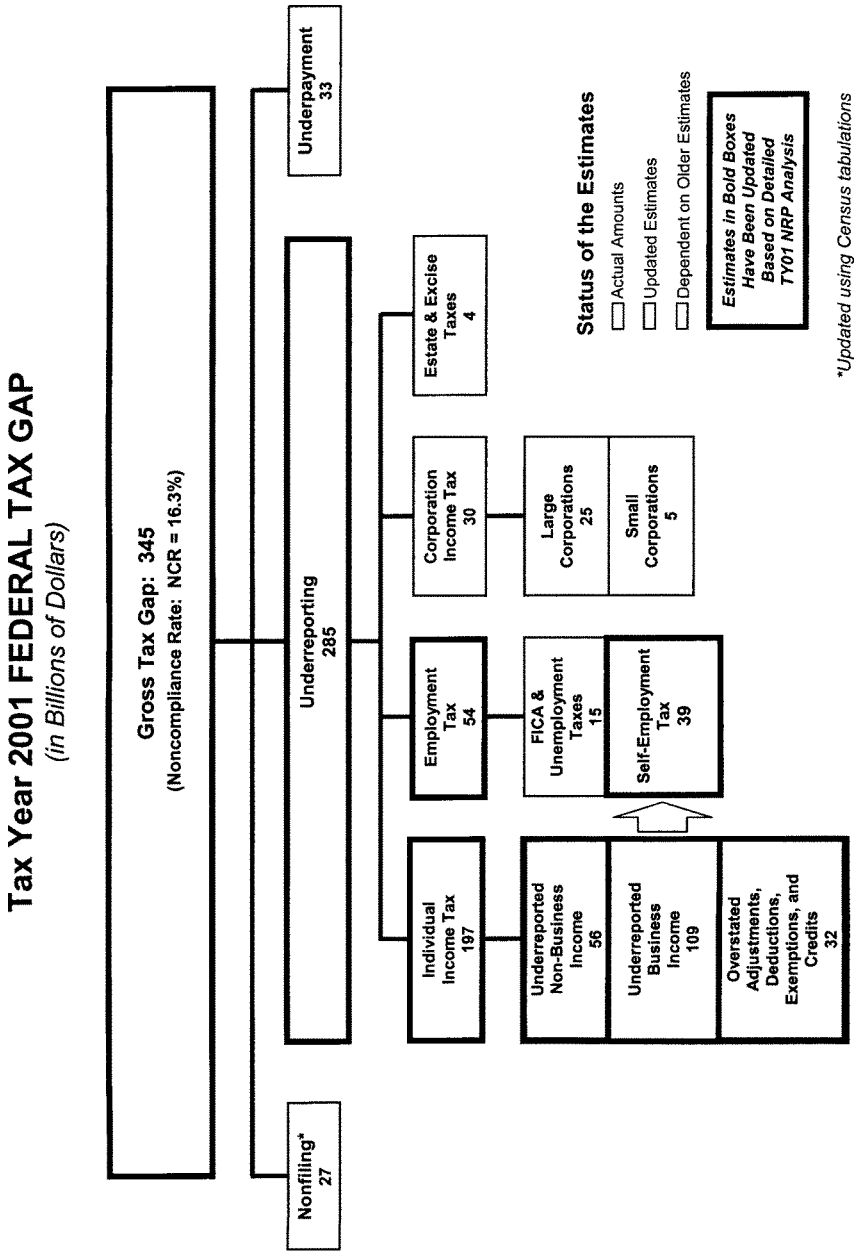
However, we owe it to compliant taxpayers to do everything we can to make sure we collect from those who are noncompliant. Otherwise, honest taxpayers are asked to carry an unfair and unnecessary burden.

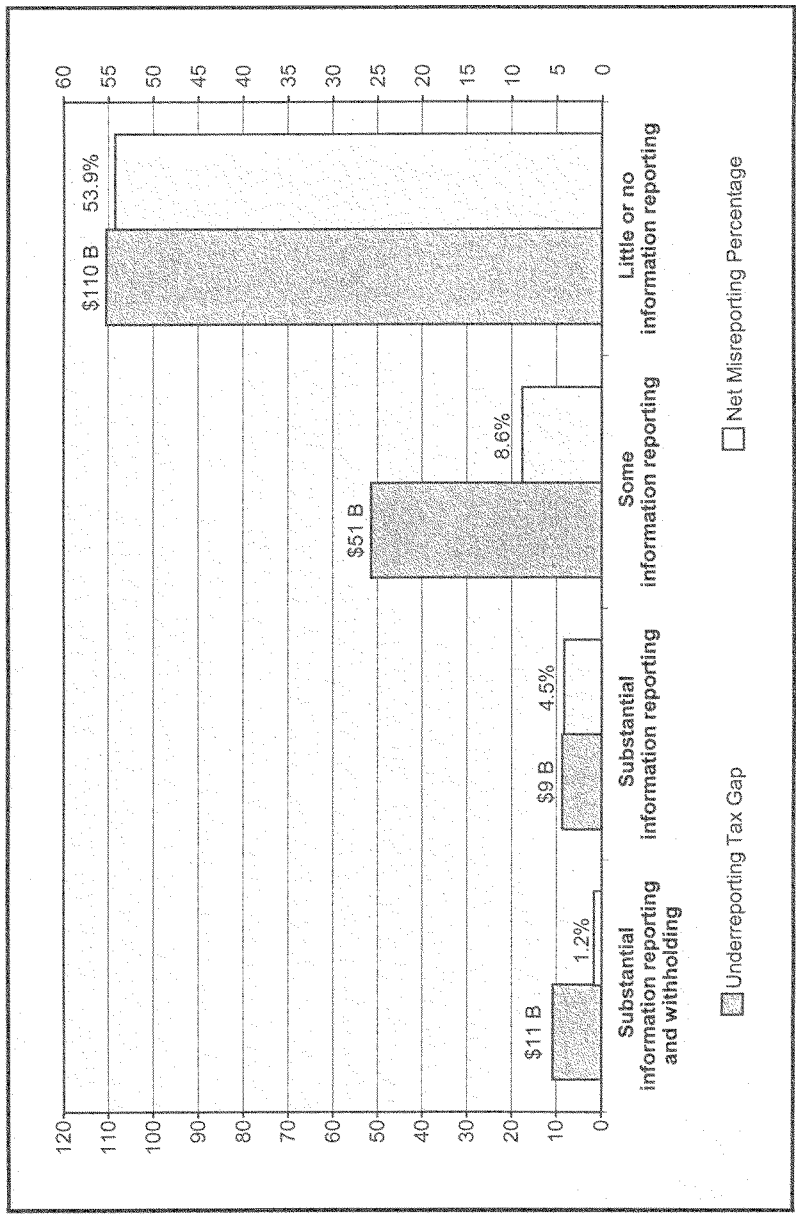
It is clear that consistent efforts to keep the complexity and unnecessary burden of the tax system to a minimum, to provide the level of service that the taxpaying public deserves, and to maintain a strong and well-targeted enforcement presence are necessary to improve compliance rates.

We intend to learn as much as we can about the extent of noncompliance and its causes so that we can devise cost-effective ways to increase compliance with our tax laws. In doing this our NRP office consults with stakeholders inside and outside the IRS throughout the development and refinement of the methodology for the studies and applies lessons learned from past compliance measurement efforts.

We are committed to applying our limited resources where they are of the most value in reducing noncompliance while ensuring fairness, observing taxpayer rights, and reducing the burden on taxpayers who comply. We do not have the resources to return to the high audit rates of the past, but we are using the NRP study results to manage our compliance programs more effectively and to design pre-filing activities that help taxpayers comply with the law.

Thank you for the opportunity to discuss the tax gap and our efforts to address it. I will be happy to take your questions.


Tax Year 2001 FEDERAL TAX GAP
(in Billions of Dollars)
Gross Tax Gap: 345
(Noncompliance Rate: NCR = 16.3%)
Nonfiling*
27
Underreporting
285
Underpayment
33
Individual Income Tax
197
Employment Tax
54
Corporation Income Tax
30
Estate & Excise Taxes
4
Underreported Non-Business Income
56
Underreported Business Income
109
Overstated Adjustments, Deductions, Exemptions, and Credits
32
FICA & Unemployment Taxes
15
Self-Employment Tax
39
Large Corporations
25
Small Corporations
5
Status of the Estimates
Actual Amounts
Updated Estimates
Dependent on Older Estimates
Estimates in Bold Boxes Have Been Updated Based on Detailed TY01 NRP Analysis
*Updated using Census tabulations


Individual Income Tax Underreporting Gap
$11 B
1.2%
$9 B
4.5%
$51 B
8.6%
$110 B
53.9%
Substantial information reporting and withholding
Substantial information reporting
Some information reporting
Little or no information reporting
Underreporting Tax Gap
Net Misreporting Percentage

Questions for the Record for Dr. Mark Mazur
July 26, 2006

From Senators Grassley and Kyl:

1. As your testimony indicates, the tax gap is commonly understood to be the difference between the amount of taxes owed to the federal government and the amount that is actually collected. How do you measure the amount of revenue that is owed to the federal government? How precise is that figure?

Answer:

There are different methods for estimating total true tax liability, depending on the type of tax and the type of compliance (or noncompliance). Taxpayers have three primary obligations: to file tax returns on time, to report on those returns their full tax liability, and to pay their full tax liability on time. The components of the tax gap (and the estimating methods) correspond to those three obligations.

- The **nonfiling gap** is defined as the amount of true tax liability that is not paid on time by taxpayers who do not file on time (or at all). We have estimates of the nonfiling gap for individual income tax and for estate tax. Given the size of the individual income tax relative to total tax receipts, it is not surprising that the individual income tax portion dominates. We have estimated the true tax liability of individuals who did not file using tabulations prepared by the Census Bureau. The Census Bureau based the tabulations on matches performed on the annual Current Population Survey (CPS) against the IRS data that Census regularly receives by law. Census has developed a tax model that allows them to estimate after-tax income in support of various government programs. They used this tax model to identify whether CPS participants had a tax filing obligation, and if so, to estimate their total tax liability. Census then used the weights for this sample to estimate aggregate results for the entire population. The IRS used aggregate tabulations of these estimates provided by Census (which made it impossible for the IRS to identify specific individuals) to estimate the total tax liability of individual nonfilers.

- The **underreporting gap** is the amount of true tax liability that filers do not report on their timely filed returns. It is total understatements net of overstatements of tax. The IRS uses audit data to estimate the true tax liability associated with timely filed returns. For some types of returns we base the estimates on thorough audits of a representative sample of tax returns. The most recent example of this is the Tax Year 2001 National Research Program (NRP) study of individual income tax returns, which subjected returns to audit if reported information could not be independently verified. However, because audits such as these cannot detect all unreported income, we estimate what was not detected from specialized studies (e.g., for tip income) or by applying a sophisticated

statistical procedure. Random audit studies of this type, however, are costly to conduct, and they draw experienced auditors away from their regular work. Furthermore, some types of returns (e.g., large corporations) do not lend themselves to thorough random audits. Therefore, we have relied on the results of regular operational audits to estimate the true tax liability for several return categories. In most cases, though, we have had to adjust the results to account for the fact that these audits are neither systematically thorough nor representative of the entire population, since the returns were selected for special emphasis.

- The **underpayment gap** is the amount of tax that taxpayers report on timely filed returns that is not paid on time. Since IRS accounting systems generally record both the amount reported and the amount paid, the underpayment gap is generally known from IRS accounting data and does not need to be estimated.

The "precision" of the estimates of true tax liability varies widely across types of tax and types of noncompliance, and is affected by several things:

- The age of the underlying data. Our set of tax gap estimates for Tax Year 2001 are based on data ranging in age from Tax Year 1981 to Tax Year 2001. Where we have had to rely on older data, we have projected the results forward to Tax Year 2001 based on the assumption that the compliance *rate* was the same in 2001 as it was for the base year. The "precision" of those projections depends on the accuracy of that assumption, which we are unable to verify without new data.

- The quality of the underlying data. Estimates based on thorough random audits, for example, are much better than those based on operational audits, since the latter estimates need to take into account the fact that the operational audits are neither as thorough as possible nor representative of the population.

- The robustness of the estimating methodologies. Some of the estimates (e.g., individual income tax underreporting) employ sophisticated statistical procedures, while others (due generally to the nature of the data) employ relatively simplistic assumptions. The more sophisticated methodologies are likely to produce estimates that are more accurate, but all of the methods probably have a significant amount of uncertainty surrounding them.

Overall, we believe that our $345 billion estimate of the gross tax gap is roughly right, and is as accurate as we can make it with available data. We acknowledge, however, that even though our estimates are recognized worldwide as the most accurate estimates of this type produced for any country, they can certainly be improved over time as we continue to gather updated, high quality data.

2. Several years ago, the IRS voluntarily suspended its program of statistical audits after intense Congressional pressure. The line-by-line audits provided useful information to the IRS, but were tremendously burdensome to taxpayers who had done nothing wrong to trigger the audit. Your testimony explains two major innovations used by the National Research Project to collect data in the absence of the full-scope audits.

- Will you explain how the "case building" data is used to supplement data from audits or selected returns?

Answer:

NRP uses "case building" data primarily to determine the accuracy of income, deductions, taxes and credits that taxpayers reported (or should have reported) on returns selected for study. The case building material helps determine whether the taxpayer needs to be contacted and whether a face-to-face audit is required. The data may also assist in the location of the taxpayer and assets owned by the taxpayer. The examiners use the case building material to assess the taxpayer's situation and help plan the examination. Upon completion of the study, "case building" data are associated with other data collected from the returns and audits to produce a rich set of compliance-related data for the IRS to analyze.

- In the "classification" process, how many returns were selected for greater review? Of those, how many taxpayers were contacted about their returns in this process? You indicate that the sample of 46,000 returns is "somewhat fewer than previous compliance studies, even though the population" has increased over time. Like any survey, the smaller the sample size, the greater the uncertainty in the data. What do you think is the margin of error for the survey?

Answer:

The NRP study database includes compliance results for 3,187 sample returns filed by taxpayers whom the IRS did not contact. (No attempt was made by the IRS to contact these taxpayers in connection with the NRP study.) Therefore, the number of taxpayers who the IRS contacted about their returns was approximately 42,800 [46,000 – 3,200].

We designed the NRP compliance studies to address not only the Voluntary Reporting Rate (VRR), but also to inform the Discriminant Index Function (DIF) return selection models and the tax gap estimates. The NRP sample estimates the VRR with 0.5% precision and a 95% confidence level.

3. Dr. Mazur, at a full committee hearing last month, Commissioner Everson identified several compliance issues faced by the IRS's Large and Mid-Size Business division, including aggressive transfer pricing, abusive foreign tax credit generating transactions, and abusive hybrid instrument transactions.

   - Are lost tax revenues associated with these types of issues included in the IRS's definition of the tax gap?

Answer:

Yes, to the extent that they involve not paying on time all tax that is legally due. One difficulty with some of these issues is that it is not always clear what amount is legally due.

- What about tax on illegal income? In your testimony, you indicated this was not included in the tax gap estimates. Why not? Does the IRS have any idea how big that number is?

Answer:

Our estimates of the tax gap do not include unpaid tax on illegal income for two reasons. The practical reason is that it is extremely difficult to ascertain either the amount of illegal income or the amount of tax that would be due on that income. A more philosophical reason is that the way to reduce or eliminate the tax gap that arises from illegal income is not to collect tax on that income, but rather to eliminate the illegal activity altogether.

4. Do you also use information from regular audits in the NRP or to otherwise assess compliance?

Answer:

Yes, if thorough audits of a representative sample of returns are not available for a given type of return, operational audit results may be used. See the answer to Question 1 for more details.

5. What is the current audit rate and how does it compare to previous years? If audits have decreased in recent years, how has that affected the reliability of the tax gap data?

Answer:

The audit coverage rates for all of the audit classes for the most recent complete fiscal year (FY2005) are provided in the table at the end of this response.

While the audit coverage rate had been declining over a period of years, it has rebounded steadily for the last three years or so. Since our individual income tax gap data results were derived from our representative sample of 46,000 tax returns, rather than from regular compliance work, the lower audit rate has not affected the quality of the data. However, for other types of tax returns, the lower audit coverage levels may lead to smaller and less frequent compliance studies.

Examination Coverage Rates, Fiscal Year 2005

Type and size of return	Returns Filed in Calendar Year 2004	Total Number of Returns Examined	Percentage Covered
	(1)	(2)	(3)
United States, total	**174,364,531**	**1,328,712**	**0.76**
Taxable returns:			
Individual income tax returns, total	130,576,852	1,215,308	0.93
Nonbusiness returns:			
Form 1040A with Total Positive Income (TPI) under $25,000	32,913,489	170,317	0.52
All other individual returns by size of TPI:			
Under $25,000	19,794,766	292,033	1.48
$25,000 under $50,000	30,869,826	185,965	0.60
$50,000 under $100,000	25,745,700	145,641	0.57
$100,000 under $200,000	8,936,850	126,116	1.41
$200,000 under $1,000,000	2,441,412	10,766	0.44
$1,000,000 or more	184,054	1,203	0.65
Business returns:			
Schedule C returns by size of Total Gross Receipts:			
Under $25,000	3,203,676	117,999	3.68
$25,000 under $100,000	3,741,677	82,542	2.21
$100,000 or more	2,149,284	78,497	3.65
Schedule F returns by size of Total Gross Receipts:			
Under $100,000	337,121	1,603	0.48
$100,000 or more	258,997	2,626	1.01
Corporate income tax returns, except Form 1120S, total	2,329,473	28,978	1.24
Returns other than Form 1120-F:			
Small corporations	2,249,416	17,858	0.79
No balance sheet returns	357,753	1,883	0.53
Balance sheet returns by size of total assets:			
Under $250,000	1,294,492	9,633	0.74
$250,000 under $1,000,000	388,411	3,735	0.96
$1,000,000 under $5,000,000	180,097	1,842	1.02
$5,000,000 under $10,000,000	28,663	765	2.67
Large corporations	54,090	10,829	20.02
Balance sheet returns by size of total assets:			
$10,000,000 under $50,000,000	28,715	3,535	12.31
$50,000,000 under $100,000,000	6,991	1,148	16.42
$100,000,000 under $250,000,000	7,357	1,287	17.49
$250,000,000 or more	11,027	4,859	44.06
Form 1120-F returns	25,967	291	1.12
Estate and trust income tax returns	3,722,408	6,591	0.18
Estate tax returns, total	74,172	6,081	8.20
Size of gross estate:			
Under $1,500,000	37,998	533	1.40
$1,500,000 under $5,000,000	30,167	3,859	12.79
$5,000,000 or more	6,007	1,689	28.12
Gift tax returns	262,164	2,125	0.81
Employment tax returns	30,494,333	33,748	0.11
Excise tax returns	834,756	16,563	1.98
Other taxable returns	[1]	412	[1]
Nontaxable returns:			
Partnership returns, Form 1065	2,546,439	8,489	0.33
S corporation returns, Form 1120S	3,523,934	10,417	0.30
Income, estate, and gift tax, and nontaxable returns, total	**143,035,442**	**1,277,989**	**0.89**

Source: *2005 IRS Data Book*, Publication 55B

[1] *In general, examination* activity is associated with returns filed in the previous calendar year. However, this relationship is only approximate. Data for other taxable and nontaxable returns in columns 1 and 3 were not tabulated.

6. What additional steps does the IRS plan to improve the measurement of the tax gap?

Answer:

We are currently conducting an NRP underreporting study of S-Corporations, which have become the most common corporate structure. This study involves about 5000 returns, spread over two tax years. We will use the results of this study to update estimates of the individual income tax gap, since S-Corp income and expenses flow through to the shareholders. We are also in the process of developing and testing more advanced statistical methods to estimate the amount of unreported income not detected by auditors, distinguishing between specific types of income.

7. How does the IRS arrive at its estimate for the number of non-filers? The Inspector General's testimony indicates it is from census data. How confident are witnesses in the accuracy of this number?

Answer:

For several years, we have estimated from the Census Bureau's Current Population Survey the total number of individual returns that appear to be required for a given tax year, based on income and demographic information provided in the survey. We have also tabulated from IRS data the number of returns taxpayers filed on time and who also had a filing requirement. Our estimate of the number of nonfilers (which includes late filers) is the estimate of the total number of returns required to be filed (from the Census data) minus the number of required returns actually filed on time. We believe that this provides a good estimate of the number of nonfilers and late filers.

8. Would you discuss how we should balance our concerns about accuracy with our concerns about subjecting taxpayers to more audits in order to gather better information? Or is there a way to gather better information without increasing the number of full-scope audits?

Answer:

We are exploring the feasibility of combining operational audit data with smaller samples of random, full-scope audits. One major issue is how much smaller the random samples can be without biasing our estimates. There are a number of statistical and procedural challenges that need to be worked out, however, and even if such a methodology proved to be feasible, it would depend on starting with a traditional random sample of full-scope audits in order to determine an adequate sample size for future combinations of random-operational audit data. While this project seems promising at the conceptual stage, there is no guarantee it will work in practice, since this would be the first application of this technique in the tax arena.

We are also experimenting with conducting multi-year compliance studies, spreading audits over several tax years. Fundamentally, however, the best way to identify and quantify emerging compliance trends is to conduct thorough audits on a representative sample of returns. Returns are typically selected for operational audit because they fit *historical* patterns of noncompliance; *new* patterns may not emerge from those cases. Therefore, the burden experienced by compliant taxpayers who participate in an NRP study, as well as the IRS resources used to conduct these studies, must be seen as an investment in making the entire tax system as fair and effective as possible. Indeed, even those taxpayers whose returns are found to be completely accurate benefit from an official statement from the IRS confirming that they are doing the right things, and those taxpayers who make mistakes learn from the audit how to determine their tax correctly. Having said that, the NRP itself represents a major step forward in reducing the burden placed on the taxpayers who are randomly selected for the study. In fact, over 3,000 taxpayers whose returns were selected for the Tax Year 2001 NRP study of individual income tax underreporting were accepted as filed and not contacted at all, and about 2,000 more were contacted by mail to verify relatively simple issues. And even when a taxpayer was audited in person, the examiner did not probe every line on the return or ask for information that the IRS already had.

9. What portion of the accounts receivable inventory does the IRS estimate to be potentially collectible?

Answer:

As of the quarter ending June 2006, the Potentially Collectible Inventory (PCI) is $91.1 billion, or about 35% of the total $263.8 billion in the Unpaid Assessment inventory. PCI consists of inventory in the locations shown in the table below. We selected these components for PCI because accounts in these locations still require a collection decision. We place accounts in the Currently Not Collectible (CNC) 530-39 inventory for one of two reasons: either the predictive models indicate it is not likely to be collected, or the account was previously in the queue, but, after a period of time, could not be assigned due to lack of resources. Our new private collection agent program and improvements in IRS collection efficiency will help us reduce the CNC resulting from resource constraints.

Activity	Amount	Portion of PCI
Notices	$19.8 billion	22%
Automated Collection System	$17.4 billion	19%
Collection Field function	$31.0 billion	34%
Queue	$18.2 billion	20%
Private Collection Agencies	$ .1 billion	0%
CNC 530-39 Inventory	$ 4.6 billion	5%
Sub-total	$91.1 billion	100%

10. What portion of the accounts receivable inventory does the IRS estimate to be "currently not collectible"?

Answer:

As of the quarter ending June 2006, $90.9 billion, or 34%, of the Unpaid Assessment inventory is considered "currently not collectible."

11. How much of the active accounts receivable has been assigned to revenue agents for collection action?

Answer:

As of the quarter ending June 2006, $31.0 billion, or 34%, of the $91.1 billion in Potentially Collectible Inventory (PCI) is assigned to revenue officers for collection action.

Activity	Amount	Portion of PCI
Notices	$19.8 billion	22%
Automated Collection System	$17.4 billion	19%
Collection Field function	$31.0 billion	34%
Sub-total	$68.3 billion	75%

12. What is the status of the remaining portion of the active accounts receivable inventory that has not been assigned for collection action (i.e., what portion is in litigation, being collected under installment agreements, etc.)?

Answer:

As of the quarter ending June 2006, about 25% of the $91.1 billion in Potentially Collectible Inventory is not yet assigned.

Location	Amount	Portion of PCI
Queue	$18.2 billion	20%
CNC 530-39	$ 4.6 billion	5%
Sub-total	$22.8 billion	25%

The remaining $172.9 billion or 66% of the Unpaid Assessment inventory is not considered active because it is in various other statuses based on collection decisions that have been made for resolving these balances:

Status	Amount	Portion of Unpaid Assessments
Installment Agreements	$20.3 billion	8%
Currently Not Collectible – Hardship	$23.6 billion	9%
Currently Not Collectible – Decedents, Defunct Corporations, Bankrupt, Unable to Locate or Contact	$59.6 billion	23%
Pending Adjustments	$15.7 billion	6%
Pending Litigation, Bankruptcy, Offer in Compromise or Criminal Investigation	$29.3 billion	11%
Amounts in Notice, TDA and CNC 530-39 with no future collection potential	$24.4 billion	9%
Sub-total	$172.9 billion	66%

13. What portion of the accounts receivable inventory is attributable to the assessments based on taxpayers who failed to file returns?

Answer:

As of the quarter ending June 30, about 32% of the Unpaid Assessment inventory is attributable to taxpayers who failed to file returns or filed only as a result of IRS compliance activity:

Status	Amount	Portion of Unpaid Assessments
Taxpayer filed during Delinquency Notice	$ 4.0 billion	2%
Taxpayer filed during a Taxpayer Delinquency Investigation (TDI)	$30.1 billion	11%
Substitute for Return prepared by IRS	$44.6 billion	17%
Business Return prepared by IRS under IRC 6020b	$ 5.6 billion	2%
Sub-total	$84.3 billion	32%

14. What portion of the accounts receivable inventory is attributable to assessments against deceased taxpayers? insolvent taxpayers? penalties and interest?

Answer:

As of the quarter ending June 30, the portion of the $90.9 billion in Currently Not Collectible inventory that is attributable to taxpayers either deceased or insolvent is:

Status	Amount	Portion of Currently Not Collectible
Deceased	$ 4.1 billion	5%
Insolvent (Bankrupt Corporations)	$ 7.6 billion	8%
Sub-total	$11.7 billion	13%

The portion of the total $263.8 billion in the Unpaid Assessment inventory that is attributable to penalties and interest is 57% or $152.2 billion:

Status	Amount	Portion of Unpaid Assessments
Assessed Penalties	$ 48.5 billion	18%
Accrued Penalties	$ 11.2 billion	4%
Assessed Interest	$ 33.3 billion	13%
Accrued Interest	$ 59.2 billion	22%
Sub-total	$152.2 billion	57%

15. How much of the active accounts receivable inventory (i.e., the amounts that are potentially collectible) is written off every year? What portion of this is attributable to acceptance of offers in compromise?

Answer:

As of September 2005, the portion of the Unpaid Assessment inventory that left inventory due to the expiration of the statutory period for collection was $56.3 billion. Offer in Compromise settlements resulted in abatements of $2.6 billion. About $21 billion or 37% of the amount that expired were amounts owed by failed financial institutions assisted by the Resolution Trust Corporation and the Federal Deposit Insurance Corporation.

16. Under current law, the IRS is required to keep accounts receivable on the books for ten years—and thus amounts that it knows are uncollectible cannot be written off for that period of time. Would it make sense to reduce that to a shorter length of time so that we have a truer picture of the accounts receivable inventory—e.g., six years?

Answer:

As of the quarter ending June 2006, 37% of the Unpaid Assessment (UA) inventory is over 6 years old, but only 17% of it is in Potentially Collectible Inventory (PCI):

Year Aged	1	2	3	4	5	6	7	8	9	10	>10
UA	58.8	32.8	20.4	18.1	17.1	18.1	16.1	15.8	18.0	21.9	26.7
PCI	37.8	15.3	7.3	5.9	5.0	4.0	3.6	3.8	3.1	2.5	2.8
Dollars in Billions											

The IRS has made significant strides in effectively managing its unpaid assessment inventory, as evidenced by the recent decline shown above. Over the last four years we have closed more balance due accounts than we received. Two initiatives have been instrumental to our success. We established Predictive Modeling—a process that uses decision analytics to select cases with the greatest likelihood for high yield. Also, we established a risk-based assignment system which elevates the priority of fresher delinquencies because they have a greater likelihood for collecting revenue and the greater potential to prevent pyramiding of additional delinquencies.

Of the accounts paid during FY 2005, approximately 97.4 % were aged 6 years or less from the assessment date. It costs very little to collect on these older accounts from refund offsets and payments to clear Notices of Federal Tax Liens. During FY 2005, the amount collected from accounts aged over 6 years was approximately $780 million.

	1	2	3	4	5	6	7	8	9	10>
%	81.7	7.5	3.4	2.3	1.4	1.1	0.9	0.7	0.5	0.5
$	25.1	2.3	1.1	0.71	0.46	0.34	0.27	0.2	0.16	0.15
Dollars in Billions										

17. Dr. Mazur, in Ms. Olson's testimony, she discusses a task force that has been established by the Small Business/Self Employed Division and the National Taxpayer Advocate's Office that will look at various data sources that may assist in fighting the tax gap. One of the sources mentioned is the use of state databases that contain sales tax, licensing, and other information. These state databases use publicly available data and compare it to tax return information to detect unreported income or unwarranted deductions. The states report that they are collecting hundreds of millions of dollars in tax revenues as a result of these databases. Could your office provide an analysis of the additional revenue that could be generated in terms of tax gap reduction if the IRS were to use these database systems?

Answer:

The IRS currently shares tax information with the states as authorized by Code section 6103. The states in turn use this information to improve tax compliance by matching it against information they have on file and identifying potential nonfilers and taxpayers who have underreported income. The IRS is testing a pilot initiative under which the states provide data back to the IRS based on certain criteria. Four states (Arkansas, Iowa, Massachusetts, and New Jersey) are participating in Phase I of this pilot. For this phase, the states matched various IRS extracts against their systems to identify individuals and businesses who had filed a state return but had not filed a federal return. The states also verified situations in which income amounts reported on a state return were greater than amounts reported on the federal return.

The IRS is testing this pilot to determine its effectiveness. If the pilot is successful, the IRS expects to expand the project to include additional states.

A major portion of the tax gap is underreporting of income. Receiving data from the states would provide additional information for the IRS to identify those individuals and businesses that have potentially underreported their income. Furthermore, information sharing with the states can help identify potential nonfilers. However, all state noncompliance does not have federal tax compliance ramifications. For instance, taxpayers may report their income correctly but improperly claim residence in a lower-tax state. In any case, it is too soon to estimate the revenue impact of such data sharing.

From Senator Hatch:

1. Mr. Mazur, you mentioned the old Taxpayer Compliance Measurement Program audits. As I understand it, these audits were very painful to those selected, but resulted in more accurate data for measuring not only the tax gap, but also other compliance information. Has the IRS given serious consideration to resuming these types of audits, but giving monetary compensation to those selected, to make the experience much less burdensome?

Answer:

We have considered that sort of approach in the past, but concluded that paying taxpayers to participate would lead to several undesirable consequences. For instance, payment might undermine the useful aspects of maintaining a professionally "adversarial" relationship with them during the audit. That is, if we paid taxpayers to participate, some them might be less likely to defend their positions and agree to something just to get the audit over with. The resulting data would likely be less accurate. In addition, we believe it might set a bad precedent to pay taxpayers selected for audit, depending on the reason for selection.

2. The most recent National Research Program reporting compliance study focuses on S corporations, which now comprise the most common corporate structure. You stated that one reason for this focus is simply that it's been over 20 years since the S corporation has been examined in this regard, but do you see any tax gap problems that are specific to S corporations? As you may know, I am a great fan of this corporate structure for a variety of reasons and have worked hard to improve the functionality of S corporations. I would welcome any thoughts on how the law governing them might be improved or how this structure may be abused.

Answer:

The number of S-corporations has increased dramatically over the past two decades, as has the range of activities in which these businesses engage. One of the trends noticed in operational audits is that S-corporations are sometimes used in the construction of abusive tax shelters. We hope that this study will shed some light on the extent of that sort of problem. We also hope to learn from the study the extent to which taxpayers do not correctly report the income, losses, and expenses that flows to them from S-corporations. In total, we hope to determine whether reporting compliance for S-corporations has improved or gotten worse over the last 20 years.

3. You note that transactions with low visibility to the IRS have the greatest propensity for underreporting, which often involve sole proprietors. How might we increase the visibility of transactions of sole proprietors at a low cost to both the IRS and to sole proprietors?

Answer:

Visibility is inherently tied to third-party information reporting. We have already implemented a number of opportunities for information reporting and, in more limited cases, withholding that are the easiest to implement. The key to keeping the cost and burden of new requirements low is to focus on requirements that would be implemented by only a relatively few large businesses; the requirements should help to make income more visible, but place little burden on sole proprietors themselves. Proposals contained in the President's Budget concerning credit card payments and government contractors, for example, have tried to follow this strategy.

From Senator Baucus:

1. Identify and discuss the five primary causes of the tax gap.

Answer:

There are really just two basic causes: some taxpayers make *unintentional* mistakes, and some taxpayers *deliberately evade* their tax obligations. There is also a middle ground where taxpayers are non-compliant due to a lack of understanding of their obligations. These basic causes have a number of underlying causes, although we cannot quantify which have the biggest impact on the tax gap. The following list highlights the most likely underlying causes:

- The complexity of the tax law: This fosters *both* unintentional mistakes (because taxpayers find the law difficult to understand and follow) *and* deliberate evasion (because it creates opportunities for noncompliance). In a related sense, due to the lack of specificity in the Tax Code and regulations, and the complexity of the law and of economic relationships, some taxpayers are prompted to push the limits between legal tax avoidance and illegal tax evasion. Moreover, to the extent that some taxpayers are exasperated or overwhelmed by the time and money they need to spend to determine and meet their tax obligations, their willingness to comply with the tax law may be eroded.

- Lack of visibility of many taxable events and amounts: Our system of self-assessment is made simpler and more effective by third-party information reporting. Not only does this information deter noncompliance, it also makes it easier for compliant taxpayers to report the correct amounts. Since sole proprietor income is generally not subject to information reporting, for example, and because of the magnitude of this type of income, the failure to report such income is the biggest single contributor to the tax gap.

- Ever-changing tax law: Instability in the Tax Code causes compliance problems. Taxpayers often use their experience from prior years as the starting point for completing their tax return. However, new tax laws may prohibit past practices. When one's tax liability changes in unexpected ways from year to year, it becomes more difficult both to determine that liability and to plan ahead for paying it.

- Need for greater enforcement of the law: Studies have shown that enforcement has more than just a direct effect on the taxpayers whom the IRS contacts; it can also affect the voluntary compliance of the general population because of the indirect effects of compliance actions. Moreover, effective enforcement gives compliant taxpayers the assurance that they are not unfairly being forced to shoulder more than their share of taxes, and levels the playing field in the marketplace.

- Aggressive tax planning: Some practitioners and promoters have become very aggressive in pushing the envelope in terms of permissible transactions. They take advantage of complexity and Tax Code inconsistencies to develop abusive tax shelters and to hide them from tax authorities.

2. To what extent is the IRS directing its resources toward the five primary causes of the tax gap? What measures are used to determine whether the IRS's efforts constitute the optimal use of resources to improve voluntary compliance and close the tax gap?

Answer:

The following points address the extent and limits of the IRS' efforts to address the underlying causes listed in our response to Question 1.

- The complexity of the tax law: The IRS strives to ensure that its tax forms, publications, and other services are as easy to understand and use as possible. However, these cannot be any simpler or clearer than the law itself. Tax law complexity is not affected much by the allocation of IRS resources.

- Lack of visibility of many taxable events and amounts: The IRS matches the third-party information it receives against what is reported by taxpayers. This matching identifies both potential nonfilers and potential underreporters. The IRS contacts the taxpayers most likely to be noncompliant and assesses additional tax as necessary. These information documents are helpful in other enforcement contacts, as well, such as audits. The IRS could cost-effectively expand the number of enforcement contacts arising from these matches, but it needs to balance these programs with other enforcement and non-enforcement programs. Having said that, the IRS cannot expand the scope of third-party information reporting; only Congress can do that. The President's FY2007 Budget included two proposals to do so, one aimed at payment cards (credit and debit cards) and another at government contractors.

- Ever-changing tax law: The IRS currently alerts taxpayers of changes in the law that may affect them. Many individuals, for example, have come to expect this information at the very beginning of the Form 1040 instruction booklet each year. However, such alerts cannot be exhaustive, and many taxpayers appear to be unaware of the changes.

- Enforcement of the law: The IRS has reversed the decline in many enforcement categories recently. The observed gains are partly due to the fact that we have introduced a number of technologies that are making our enforcement more productive and smarter. The IRS seeks to maintain a balanced enforcement effort, pursuing the most cost-effective workload in each program within resource and other constraints.

- Aggressive tax planning: Treasury has required taxpayers who engage in "listed" transactions intended to reduce tax liability disclose that fact. There are currently over 30 "listed" transactions. Moreover, the IRS established the Office of Tax Shelter Analysis (OTSA) to serve as a clearinghouse for all information related to tax shelter activity. The IRS is reviewing disclosure requirements for other transactions and has required large corporations to track the differences between

book income for financial statement purposes and taxable income on schedule M-3.

3. Identify and discuss the five primary impediments to voluntary compliance.

Answer:

These are discussed in response to Questions 1 and 2.

4. Identify and discuss the five primary burdens of taxpayers in meeting their tax obligations.

Answer:

- The complexity of the tax law: The Tax Code contains many hard-to-understand rules and exceptions to those rules. The result is that most individual taxpayers have someone else prepare their returns (usually at some cost). The time and money spent keeping up with all this complexity, and the uncertainty due to the incomprehensible nature of the law, represent a huge burden on taxpayers in excess to the tax burden itself.

- Ever-changing tax law: Taxpayers often find it difficult to keep up with changes in the tax law and to determine which of the changes might affect them. They must expend resources to be sure their returns are compliant with current tax law and to ensure they are not under-paying or over-paying their taxes.

- Record-keeping: In general, taxpayers must maintain their own records of income received and relevant expenses incurred. This record-keeping is often a very challenging, time-consuming, and expensive task, especially when these records relate solely to meeting tax obligations.

- Mis-estimating liability: Taxpayers seem to adjust their withholding (based on their experience in prior years) to ensure that they get a refund instead of owing more tax when the return is filed. Tax withholding simplifies the payment of tax throughout the year. However, even wage withholding can be complicated and inexact in the context of multiple concurrent jobs, part-year jobs, or the presence of various deductions, adjustments, and credits or non-wage income. Making estimated payments to supplement withholding is an even more daunting task, particularly if one's circumstances change from year to year.

- Increasing complexity of economic relationships: Taxpayers are entering into ever more complex relationships with employers, vendors, and each other. Some of these relationships (like distinguishing between being an employee and independent contractor) have outpaced the ability of the IRS to provide helpful guidance.

5. Identify and discuss the five primary concerns of IRS external stakeholders.

Answer:

The Office of National Public Liaison (NPL) and the Small Business/Self-Employed Stakeholder Liaison office work together with several organizations that represent the tax professional community and play a critical role in educating taxpayers about their responsibilities in filing, reporting and paying federal tax. These organizations represent attorneys, CPA's, Enrolled Agents, the tax software and technology community and the information reporting industry.

NPL asked each of these groups, including the Information Reporting Program Advisory Committee (IRPAC) and the Internal Revenue Service Advisory Council (IRSAC), to discuss their five concerns regarding the Tax Gap. The views they expressed are not necessarily those of the IRS. Presented below are the five primary concerns our stakeholders presented to us, including several legislative proposals they believe would help to address the concerns. The IRS does not endorse these suggestions, and believes any resource or legislative proposals would need to be carefully considered by all levels of the Administration.

1) **Funding:** These stakeholders state that the IRS requires enormous resources to administer the tax laws. As a whole, IRS stakeholders feel that providing additional funding will support the IRS mission of providing customer service and taking enforcement action as appropriate. This extra funding would go towards business modernization and an increased audit and collection presence. This increase would help the IRS address the three major components of the Tax Gap; underpayment, non-filing and under-reporting. Another aspect of increased funding that the stakeholders almost unanimously agree on is the need to increase audits, or at least the ability to increase audits. They do understand that a fully-funded audit process will not eliminate the Tax Gap.

2) **Tax Law Complexity:** These stakeholders state that Congress and the IRS have addressed this particular issue many times in many ways and yet it is still a major concern. Any help in simplifying the tax code would reduce burden for taxpayers, tax professionals and the IRS itself. Simplification could come in many forms. Simplification in the area of small business taxes seems to be an area of concern for all parties involved. If, in fact, small businesses are the backbone of our economy, reducing their burden will increase revenue, and go a long way toward reducing the Tax Gap.

3) **Education:** These stakeholders state that the lack of education in every aspect of the tax system is at the core of the problem. People often simply don't know what to do. This education would begin early in our elementary institutions and continue through the taxpayer's entire lifecycle. This suggestion crosses into the "complexity" and "funding" concerns, but all sectors feel that education is preventative maintenance. The Tax Gap problem is particularly acute in the Individual and Small Business sector. Educating an entire population of individuals who operate Schedule

C and Subchapter S corporations seems to be a vital tool in reducing the Tax Gap. This proactive education component should be a Congressional mandate and be on the President's Management Agenda. This proactive effort would help create a paradigm shift within the Department of Education with regards to the treatment of tax education matters.

4) **Document Matching:** This area of concern covered a large amount of ground within the IRS external stakeholder community. To some stakeholders it meant working more closely with the banking and securities industry. To others, in fact almost everyone, it meant a dramatically increased cooperation between states and the IRS. Members of IRPAC were particularly vocal in the sharing of programs that states use for tax compliance. They all felt that the states are quite efficient in tax administration. They felt each of the agencies within the respective state coordinated well with each other. For example, if a small business or an individual were to apply for a license, the state would complete a cross-reference check of that person's business and personal identification numbers before issuing a license. The IRS completes reference checks only after a tax liability exists. Privacy concerns not withstanding, their concern is that the IRS does not take advantage of a vast pool of information.

5) **Cash Economy:** Another frequently discussed concern among stakeholders is the vast amount of revenue lost to the cash economy. The lack of reporting on income paid to independent contractors was the primary area of concern. The suggestions ranged from lowering the threshold for reporting to $400, to requirements for absolute Form 1099 reporting on all types of transactions for business entities, including corporations. This suggestion included reporting payments to all contractors and subcontractors. Requirements to withhold taxes on payments to independent contactors should be explored as well. One respondent mentioned a state program that requires independent contractors to sign a form opting out of withholding for the first year they are in business. If the income is not reported, the withholding would be mandatory. The tax practitioner community, in particular, is keenly aware of non-compliance due to the cash economy. Many potential clients come to them wanting to file a tax return regardless of the "cash economy red flags" on the return or the supporting documentation. These clients are turned away and the return is either not prepared or prepared by less than scrupulous return preparers. The IRS stakeholders also expressed concern about the need to develop standards or definitions for independent contractors versus employees. Countless revenue-improving scenarios address the cash economy. As with the above mentioned concerns, funding seems to be the key.

Note: The tax software and technology industry voiced some of the same concerns listed above, but their primary concern did not fit neatly into the five categories. Their primary concern is with any new tax policy theories suggesting that compliance and revenues could be improved or increased if the government were to insert itself as direct service provider for electronic tax preparation. According to these stakeholders, high quality tax preparation software allows taxpayers and practitioners to efficiently

and accurately navigate the tax code while completing tax returns. It's this ease of use and fairness of these products and services that contribute to voluntary compliance.

6. Identify and discuss the five most significant impediments to the IRS's efficiency and effectiveness. What is the IRS doing to eliminate or mitigate these impediments?

Answer:

1) The major impediment to the IRS' efficiency and effectiveness is the inherent complexity of the tax code. Because of this complexity, taxpayers often fail to understand their true obligation. They want to pay their fair share, but they have difficulty determining what that is. Complexity is also used by those that are intent on tax avoidance to disguise the true nature of their tax obligations. Depending on the nature of the taxpayer, this obfuscation may be discovered and dealt with in the course of an audit. However, in the case of large taxpayers, it may mean a prolonged battle with well-funded and highly-skilled accountants and lawyers, thus draining IRS resources from other areas.

2) Closely associated with the complexity of the Code is its ever-changing nature. Since 1986, there have been over 15,000 changes to the tax code. Like complexity, repeated changes to our tax laws necessitate the need for greater taxpayer service as individuals and businesses become familiar with new provisions that affect their tax obligations. It also places an increased strain on our enforcement resources as we deal with savvy practitioners who take advantage of uncertainty and stretch their interpretation of new provisions in ways the Congress never imagined. In dealing with both the complexity of the tax law and the changing nature of the code, we are attempting to apply the mantra that Commissioner Everson has instilled in all IRS employees: service *plus* enforcement *equals* compliance. For example, we are stepping up taxpayer service through such things as the Taxpayer Assistance Blueprint and through improved electronic tax administration. We are also utilizing research designed to improve our audit selection formulas and increasing audits of high income individuals and businesses.

3) Our efficiency and effectiveness is also challenged by the increasing globalization of our economy. A growing percentage of large and mid-size business tax filings are from multinational companies that have a myriad of subsidiaries and partnerships operating within an enterprise structure where the ultimate parent is as likely to be foreign as domestic. In addition, a growing number of U.S. businesses acquire raw materials, inventory, financing, products and services from foreign businesses. These events are natural outcomes of an increasingly global economy and businesses have the right to optimize their global structures. Nonetheless, the complexities of globalization and cross-border activity continue to challenge the Code and U.S. tax administration. Complexities of globalization and cross-border activity create opportunities for aggressive tax planning that have the potential to contribute significantly to the tax gap. It is not just large corporations taking advantage of this globalization. Wealthy individuals are

seeking ways to shelter income by moving it offshore or by participating in tax shelters organized by unscrupulous promoters who move in the shadows of the global economy. The IRS is moving aggressively to try to deal with these issues. We have in place the Offshore Credit Card Program (OCCP) which is a compliance initiative designed to identify taxpayers who use offshore bank accounts to hide income and offshore credit cards issued by secrecy jurisdiction banks to repatriate the unreported income. To date, we have trained over 1,200 revenue agents to examine offshore credit card activities and identify abusive offshore tax avoidance transactions. In January 2006, the IRS and the tax administrations of nine other countries agreed to the establishment of the so-called "Leeds Castle" Group. Under this new arrangement, the commissioners of the revenue bodies of China, India, and South Korea agreed to meet regularly with their counterparts from the US, the UK, Japan, Australia, Canada, France and Germany to consider and discuss issues of global and national tax administration in their respective countries. Commissioner Everson was also recently elected Chairman of the Forum on Tax Administration, a panel that is part of the Organisation for Economic Co-operation and Development (OCED). OCED is a coalition of 30 nations committed to democratic government and market economies. Mr. Everson has stated a desire to use this position to foster greater cooperation in the international community to fight the proliferation of abusive tax practices. Another body that serves a very important strategic role for the Service in the realm of our international activities is the Joint International Tax Shelter Information Centre, or JITSIC. JITSIC, a joint effort of the Service and the tax bodies of the UK, Australia and Canada, helps us identify and share information on a real-time basis about abusive tax avoidance transactions. It has sharply improved our knowledge and understanding in a number of areas, including developments in the areas of foreign tax credit generation and so-called hybrid instrument transactions used to improperly avoid U.S. taxes, which have been identified as among our most important issues in corporate tax administration.

4) We are also challenged by our ability to keep pace with savvy practitioners and promoters who constantly seek to push the envelope in terms of permissible transactions. These practitioners understand and utilize all of the other areas previously mentioned—the complexity of the code, its ever changing nature and the globalization of our economy—to the benefit of themselves and their clients. We have taken several steps to deal with this challenge. We have created the Office of Tax Shelter Analysis (OTSA), which serves as a clearinghouse for all information relating to tax shelter activity that comes to the attention of the Service. The Office of Tax Shelter Analysis will, among other things, review all disclosures by promoters and taxpayers under disclosure regulations for the purposes of identifying potentially improper tax shelter transactions, identifying taxpayers that have participated in such transactions, and better assessing the overall extent of tax shelter activity by corporate taxpayers. We currently have over 30 "listed" transactions. We have also strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. Treasury regulations set forth rules

governing what does and does not qualify as an independent opinion about a tax shelter. Specifically, new Treasury Department regulations took effect last June which revise Circular 230 governing tax practitioner behavior. The new regulations establish standards for written tax advice prepared by practitioners. Further, the IRS recently proposed additional revisions to Circular 230 to make disciplinary proceedings more transparent so that practitioners may learn the types of behavior the IRS is likely to challenge under the Circular.

5) Ultimately, like any business facing difficult challenges, the IRS is no better than the people who do the work, and maintaining and attracting an educated, flexible workforce is perhaps our biggest challenge. People are the key factor in business performance. Our service to taxpayers hinges on the effectiveness of our employees—and on our investment in their development. The sincerity of our commitment to this goal must be unequivocal and our employees must perceive it as such. Our leaders are trained to effectively manage people by challenging the workforce and demonstrating high standards of honesty, trust, openness and respect. The IRS also sustains an aggressive recruitment effort that strengthens and extends partnerships with key colleges and universities and with private sector business organizations. We continue to seek ways to be recognized as an "employer of choice" for talented college graduates. We will continue to evaluate alternatives for employee learning and development and implement improvements to close critical competency gaps. We are fast-tracking new hires into the field by adapting our training programs to maximize innovative training concepts such as remote learning, just-in-time modules, and training tailored to the specific needs of new hires that, for example, may have tax knowledge but need training in procedures. To a large extent, our ability to attract the best and the brightest is dependent on the resources provided in our annual appropriation. To continue activities needed to develop, train, and retain IRS employees, it is important that Congress support full funding of the President's FY 2007 budget request for the agency.

7. Identify and discuss the five most significant resource challenges facing the IRS.

Answer:

1. Legacy system infrastructure funding

Funding for adequate information technology infrastructure is the IRS' highest priority. The IRS cannot significantly improve compliance through its service and enforcement initiatives without a robust and well-maintained IT infrastructure.

IT Infrastructure investments support services—both to taxpayers and to other government agencies—and enforcement by providing IRS frontline employees with the basic tools necessary to perform their jobs. A modernized and secure infrastructure will enhance the speed, security, and functionality necessary to keep pace with a modern—and increasingly automated—economy. The IRS must keep pace with the growing demand and volume of electronic submission, payment, and

refund transactions for tax remittances, and offer taxpayers a greater variety of faster alternatives for satisfying their tax obligations. These efforts will continue to place greater demand on the IRS to provide a modernized and secure IT infrastructure.

2. Continuing BSM program funding

A successful modernization program is critical to long-term tax system operations. Management of the Business Systems Modernization program has improved, with releases of Filing and Payment Compliance, Customer Account Data Engine, and Modernized e-File successfully deployed this year. Current progress with delivering consistent performance and the Earned Value Management employed by the Business Systems Modernization program have resulted in a renewed confidence of the IRS' stakeholders. In recent testimony about the FY 2007 modernization request, the General Accountability Office (GAO) identified the program as being critical to the IRS' ability to meet taxpayer service and enforcement goals. The GAO specifically recognized the benefits of the program's expansion of electronic filing capability, as well as providing reliable and timely internal financial management.

The IRS' vision for its infrastructure systems will align with and support the Strategic Plan. This year the IRS established a team of information technology (IT) and business specialists to develop an IT modernization roadmap showing how the IRS can effectively meet IT modernization goals in an incremental approach that provides near-term value.

Each tax administration project identified in this plan addresses a core IRS strategic business priority. Program operations will continue to focus on improving program performance, improving and streamlining management process disciplines, and ensuring delivery of projects on time, on budget, and on scope by taking a greater ownership and leadership role in managing the Business Systems Modernization program.

3. Finding/Retaining qualified staff

The Internal Revenue Service has more than 100,000 employees. The IRS workforce is widely diverse in many ways, including job series, ethnicities, and geographic distribution. The IRS has a large seasonal workforce that accounts for about 23 percent of the employee population during peak workload seasons. More than three-quarters of the IRS annual budget finances salaries and related expenses.

Human capital is the IRS' most critical resource, and recruitment and hiring of mission-critical talent is a priority. Experienced staff are retiring at increased rates (from 2.6 percent in 2001 to 4.3 percent in 2005). This trend will continue for the near future. In addition, about three percent of IRS employees change positions each year and this movement often creates job competency gaps in the positions vacated. These gaps are particularly critical in the enforcement and compliance fields, which require specialized training.

The Service-wide strategic approach to employee retention includes on-going planning of skill sets and analysis of positions in need of retention efforts, as well as utilization of retention bonuses, relocation incentives, Telework, and flexible employment options, and other appropriate retention tools.

4. Optimizing resource use given challenging resource constraints

Absorbing increased costs from pay raises above the budget level proposed by the Administration is a significant resource challenge for the IRS. Approximately 75 percent of IRS' budget funds the salary and benefit costs of employees that are critical to delivering a successful filing season and enforcing our nation's tax laws. To this end, the Service remains proactive and constantly seeks opportunities to improve productivity in order to accommodate increased workload demands and unanticipated funding requirements.

In addition, with the objective of minimizing the need for appropriated resources, the FY 2007 President's Budget proposed to offset base taxpayer service programs with $135 million in receipts from *new and increased* user fees. Historically, the IRS has used the revenue from existing user fees to pay for mandatory, unbudgeted requirements, such as the implementation of the Child Tax Credit and, as anticipated in FY 2007, to administer the new Telephone Excise Tax Refund. However, should demand for, and ultimately revenue from, these fee-charged services decline, the Service's ability to fund emerging unexpected needs will be placed at significant risk.

5. Make a Multi-Year Commitment to Research

Ongoing investments in research are essential to identify opportunities to optimize the IRS' delivery of taxpayer services and enforcement of our nation's tax laws. Per the recently released Treasury tax gap plan, the IRS is committed to maintaining this research effort. More research is needed to better understand the impact of customer service on voluntary compliance as well as the relationship between compliance and taxpayer burden. In addition, expanded research will identify the most egregious areas of noncompliance and ensure that the IRS targets its enforcement resources at the areas of greatest opportunity for tax gap reduction. Regularly updating compliance research ensures that the IRS is aware of emerging vulnerabilities. Furthermore, more research will establish accurate benchmarks and ultimately measure the effectiveness of IRS efforts, including the effectiveness of any comprehensive strategy to reduce the tax gap.

8. Identify and discuss the five primary impediments to delivering top quality customer service.

Answer:

Providing quality customer service and continuing to improve those services is a strategic priority for the IRS. Since September 2005, the Taxpayer Assistance Blueprint (TAB) team has been conducting extensive research directly with taxpayers

to identify taxpayer needs and preferences for receiving quality customer service. The IRS delivered the TAB Phase 1 Report to Congress in April 2006. The TAB Phase 2 report, which we expect to deliver to Congress in January 2007, will validate the service recommendations through extensive primary research with taxpayers. Current ongoing customer preference and needs research includes surveys, focus groups, and experimental research aimed at providing customer-centric information to decision makers. Although the IRS has not yet completed the TAB Phase 2, the work that has been performed provides some insight as to challenges associated with delivering top quality customer service. We believe the research and analysis to date supports the following five primary impediments to delivering top quality customer service.

1. **Complexity of the tax code** – It is widely recognized that the tax code itself has become increasingly more complex over the years. In addition to complexity, each year tax law changes occur that have direct impact on a large number of taxpayers. The Service is continually faced with the formidable challenge of informing and educating taxpayers, the tax practitioner community and IRS employees on these changes to ensure compliance with tax laws, as well as delivering quality customer service. While the Service has little control over the complexity of the tax code, we will continually strive to identify and implement more effective means of timely informing and educating affected stakeholders on tax law changes. In addition, from a customer service delivery vantage point, we are developing improvements, such as technology based decision-making support tools, to ensure the accuracy of tax law applications.

2. **Lack of credible taxpayer-based empirical data on causes of inadvertent non-compliance** – Operating on the premise that there are two types of non-compliance, intentional and inadvertent, the fundamental customer service challenge is to minimize the amount of inadvertent filing, payment and reporting non-compliance. To address the challenge, the IRS needs a better understanding of the causes of inadvertent non-compliance; however, there is very little research available to draw any quantitative and or qualitative conclusions. Through TAB, we have initiated several research initiatives to gain additional insights on the causes of inadvertent non-compliance.

3. **Expanding use of third parties for services** – In 2003, only 32% of taxpayers contacted the IRS for pre-filing or filing assistance. Last year, 81% of taxpayers went to practitioners, community-based volunteers or used software for filing assistance. Consequently, the IRS directly delivers customer service to a relatively small portion of taxpayers and can only indirectly influence the quality of services provided to the majority of taxpayers. A key service improvement opportunity for the IRS would be the enhancement of services provided to practitioners, and thereby passing on a positive impact of services practitioners provide to taxpayers. The TAB initiative is evaluating the role intermediaries play in providing services and opportunities for the IRS to enhance third party service delivery.

4. **The scope and diversity of the taxpayer base and the challenges to serve them on a "first-come/first-serve"** – The taxpaying population is broad and constantly changing. The population is growing, the average age of taxpayers is increasing, the population is becoming more ethnically diverse, and the use of technology is increasing. The IRS has the unique and challenging task of delivering customer service to taxpayers in this continually evolving demographic and economic environment. The IRS offers a range of services through a variety of channels that serve taxpayers on a first-come, first-served basis. The TAB initiative is addressing questions such as whether the IRS should focus its service efforts on those individuals with greater "need," continue its "first-come, first-served" approach, or focus on facilitating the "needs" of the taxpaying public as a whole. Recognizing that there are limits to the amount of service the IRS can provide, perhaps this is the greatest challenge of all.

5. **Challenges to keep pace with taxpayer expectations** – Over the years, technological advances that are available in the marketplace have shaped taxpayer expectations regarding service applications and delivery to a much higher level.

9. Identify and discuss the five primary technological impediments the IRS is experiencing.

Answer:

1. **Aging Legacy Systems** – Many of our core legacy systems are written in outdated coding languages and are difficult to maintain, update, and document. They also require specialized skills that few software programmers have or are interested in obtaining. In addition, the data associated with these applications is stored in outdated technology, making access to this data by other systems difficult and costly. We are mitigating this risk by consolidating application development efforts where possible and negotiating more effective license agreements.
2. **Disparate and Aged Infrastructure Environment** – Our prior organizational structure lent itself to many technical stovepipes and duplicative solutions for similar issues. To manage this large computing environment, we need to simplify and standardize it, including revisiting existing solutions, continuing our focus on standards, and improved migration planning.

   Another key technology challenge that the IRS faces is the effective management of the complex, large, and disparate infrastructure. Every new technology presents a challenge when scaled to our enterprise. Specifically, the relentless changes in technology and new versions of existing technology are difficult to integrate into our large 7x24x365 infrastructure. In part, due to the age of many of our legacy systems as well as the sheer number of processing applications, we need to maintain several versions of software on our production servers at all times.

3. **Reliance on Technical Resources** – We know that the IRS cannot rely solely on staffing levels to resolve technical gaps. In addition, we will experience a significant talent drain in the next several years as the IRS technical staff currently supporting and developing IT solutions is retiring at a very fast pace. While we are continually reviewing our succession planning efforts and developing hiring plans, the recruitment and hiring of technical professionals is time-consuming, particularly in a competitive marketplace. We plan to allow transition times for key positions and staff as early as practical to minimize the negative impact of a wave of retirements over the next 2–4 years. We can also insulate the organization against the negative impact of both of these events by more effectively identifying and implementing proven software tools that are easier to maintain and operate.

4. **Complexity of the Tax Code** – Each year the IRS must implement the provisions of the tax code within the context of systems, applications, processes, procedures and constraints that have been in place for more than half a century. While this operation is difficult on its own, the IRS also has to implement yearly tax law changes. The IRS cannot delay modernization efforts and must work within the constraints of yearly tax changes. The combination of delivering modernization enhancements and functionality with the yearly tax law changes is a challenging task to manage while still trying to meet the IRS electronic filing goals.

5. **Business Process Alignment** – Many of our technology impediments are actually organizational and business transformation issues. There is a very tight coupling between legacy business process and technology solutions. In part, due to the size of our organization, there are significant obstacles caused by cumbersome business processes. Time to value is constrained by implementing new technologies without changing the business process. Modernization is an evolutionary process that attempts to leverage the benefits of legacy systems and services without the legacy overhead cost of people, process, and technology.

   In attempting to upgrade our internal processes to better manage our technical investments, we need to extend our reach toward a cohesive governance process that is flexible enough to address all IT initiatives based on varying levels of risk and complexity. Our focus is to have the right levels of controls for these initiatives and establish accountability for outcomes. The IRS is currently taking steps to address this problem, but will continue to face obstacles as modernization continues.

10. Identify and discuss the five primary collection impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?

Answer:

The Congress has before it for consideration several bills that would improve the ability of the IRS to collect from those who disregard their tax obligations.

Congressional support for IRS efforts to improve its collection processes is essential if we are to continue to make improvements in collection performance.

1. The Collection Due Process provisions of sections 6320 and 6330 provide taxpayers the opportunity for a hearing before the Office of Appeals to raise relevant issues when the IRS files a notice of federal tax lien or notifies the taxpayer that it intends to seize property to satisfy an unpaid tax liability. While this opportunity is an important taxpayer protection, the process is inherently time consuming and allows some taxpayers to employ delaying tactics while continuing to incur new liabilities, particularly employment taxes. The IRS may assess several additional quarters of employment taxes while the hearing process runs its course, and the IRS is generally prevented from collecting during this time. The Chairman's modifications to S. 832, the Taxpayer Protection and Assistance Act, adopt the Administration's proposal to grant no right to a pre-levy hearing for employment tax cases. Levy would be permitted to commence prior to granting a hearing, and, depending on the facts and circumstances of the case, to continue throughout the hearing process. Taxpayer rights would be protected by granting taxpayers the right to a hearing before Appeals—and judicial review of an adverse decision by Appeals—after levy is made.

2. A second impediment often encountered when attempting to collect is the misuse of IRS processes to delay collection when there is no legitimate dispute as to the amount owed and the taxpayer has not proposed a genuine alternative to enforced collection. The statutory provision of the right to a hearing prior to levy and the opportunity to appeal the rejection of an installment agreement or offer in compromise serve to protect taxpayers who are making good faith attempts to reach resolution with the IRS, but also create a clear opportunity for the unscrupulous to delay legitimate and necessary collection action. The modifications to S. 832 would expand the penalty applicable to frivolous returns so that it would apply to other documents, such as hearing requests and offers in compromise. It would also substantially increase the penalty from the current $500 to $5000 and affirm the ability of the IRS to disregard such frivolous documents and proceed with collection. These changes would maintain the availability of these protections to taxpayers with bona fide concerns while making them less attractive as delaying tactics.

3. Some of the most difficult cases for the IRS to resolve are those involving businesses which repeatedly fail to pay employment taxes—referred to as "pyramiding"—but have little or no assets from which to collect. In such cases, the Code's lien and levy provisions are of little use as there are minimal assets. Section 6331(f) prohibits levy on property if the amount of the expenses estimated at the time of the levy in conjunction with the levy and sale of property exceeds the fair market value of the property. Administrative collection action is therefore not a viable option in many of these cases. Section 7512 can be used to require special accounting for withheld taxes, but the monitoring requirements are labor intensive, the prosecution potential is limited, and the record of relapse when active monitoring ends is substantial.

The IRS has made limited use of section 7402 to seek injunctive relief through the district courts. The costs of litigation, both for the IRS and the Department of Justice, are significant. Some district courts have also expressed concerns that the monitoring of an injunction and any follow-up litigation shifts the compliance monitoring function from the IRS to the courts.

The Administration is actively considering whether modification of existing levy provisions would facilitate resolution in these difficult cases, or whether additional administrative and judicial collection tools are needed.

4. The significant expense associated with calculation, withholding, accounting for, and paying withheld income taxes and Federal Insurance Contribution Act taxes prompts employers to look for ways to avoid this compliance requirement. The IRS has seen increasing reliance on employee leasing arrangements as a method of liability avoidance. The providers of these arrangements are known as professional employer organizations and their treatment under the employment tax rules is a gray area. The Administration's most recent budget request included a provision that would treat a certified professional employer organization as the employer of any work-site employee performing services for any customer of the certified professional employer organization, so long as the certified professional employer organization met certain requirements. This treatment is limited to compensation remitted to the work-site employee by the certified professional employer organization. Legislation allowing this treatment would curb the abuse in this area.

5. The use of successor entities is also a longstanding method of avoiding employment tax payment. A succession of state law entities with limitation of liability, historically corporations, but more recently state law limited liability companies, are organized by the same principals/owners/investors as the vehicle for business activity. These businesses are often characterized by under-capitalization and limited asset ownership, limiting the Service's ability to enforce administrative tax collection. The section 6672 trust fund recovery provisions relative to responsible persons are used to pursue the withheld portion of liability, but the employer matching portion is lost when the entity is unable to pay.

   The IRS is exploring whether the information provided by taxpayers when applying for an Employer Identification Number could be better utilized to combat non-compliance by successive entities with the same principal owner.

11. Identify and discuss the five primary examination impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?

Answer:

The following are five examination impediments that affect the IRS's ability to fully address the tax gap:

1. **Tax Law Complexity** – The complexity of the tax law is a significant factor in causing the tax gap, which can be seriously addressed only in the context of fundamental tax reform and simplification. Helping taxpayers better understand their obligations under the current tax law will facilitate compliance, but simplifying the tax code would have a big impact on reducing the tax gap. The IRS Office of Taxpayer Burden Reduction continues to lead burden reduction efforts for the IRS. The office's critical strategies focus on decreasing the amount of time and money taxpayers must expend to meet IRS requirements by simplifying tax returns, streamlining internal policies and procedures, promoting less burdensome rulings, and assisting in the development of a more accurate burden measurement methodology.

   Complex tax laws also create barriers for examination personnel to properly enforce the law. Complexity makes it harder to gather the needed facts to make determinations and when the IRS makes determinations, complexity of the law raises the likelihood of disputes arising between taxpayers and the IRS.

2. **Third Party Reporting** – Research indicates a close relationship between items subject to information reporting systems and taxpayers' reporting of such items on their tax returns. However, there have been no substantive changes to third party reporting statutes since 1986. The President's FY 2007 budget proposal requiring credit and debit card companies to issue Forms 1099 to merchants reporting gross annual reimbursements will be an important step in increasing third party reporting that we expect will reduce underreporting.

3. **Hiring and Training Skilled Auditors** – The workload resulting from efforts to reduce the tax gap, combined with the loss of experienced employees, requires a steady stream of new resources. Once a new employee is on board, sufficient time is necessary to adequately train him or her to ensure he or she has the required knowledge to deal with the tax issues of the 21st century. During this time, we will need to take resource support from current skilled professionals to train these new hires, allowing for a sufficient learning curve for new hires to become effective and efficient in their jobs.

4. **Globalization** – Globalization, the mobility of capital, the immediacy and fluidity of information and knowledge transfer, and the access individuals and businesses have to sophisticated tax planning and, in some cases, tax avoidance advice and products is increasingly challenging tax administration. Further, the lack of transparency with nominees, proxy registrations, and registered agents in offshore secrecy jurisdictions prevent or hinder the Service in identifying true ownership. There have been a number of steps in the last several years to increase international cooperation and improve our treaty relationships as well as the administration of the

provisions of our tax treaties. Earlier this year, the IRS and the tax administrations of nine other countries agreed to the establishment of the so-called "Leeds Castle" Group. Under this new arrangement, the commissioners of the revenue bodies of Australia, Canada, China, France, Germany, India, Japan, South Korea, the United Kingdom and the United States agreed to meet regularly to consider and discuss issues of global and national tax administration in their respective countries, particularly mutual compliance challenges. In addition, the IRS and the national tax agencies of the United Kingdom, Canada and Australia established the Joint International Tax Shelter Information Centre (JITSIC), a joint effort to identify, develop and share information about abusive tax avoidance transactions on a real-time basis. Legislation might be needed to address abuses and loopholes as they are developed.

5. **Technology** – Tax administration has an opportunity to capitalize on numerous developments in technology. One such example that could have potential impact on the tax gap is the implementation of Extensible Markup Language/Extensible Business Reporting Language (XML/XBRL) Standards for defining and tagging tax data. This technology could substantially improve the IRS's ability to select and examine those returns with significant tax potential. XML provides a mechanism to attach uniform tags, or labels, to data. XBRL is a variation of XML in which financial statement data is tagged based upon various Generally Accepted Accounting Principles (GAAP) standards. Funding and development of XML and XBRL initiatives have significant potential to reduce taxpayer burden, standardize filing, increase processing efficiency, and provide opportunities for new electronic audit tools to identify unreported gross receipts.

   Continued funding for technology, such as proposed in the FY 2007 President's Budget, to allow the IRS to keep abreast of this ever changing environment is essential for the IRS to address the tax gap.

12. To what extent will the high percentage of retirement-eligible employees at the IRS impact the tax gap within the next five years? 10 years?

Answer:

Most IRS programs require both training and experience to perform well. As a result, both enforcement and non-enforcement personnel increase in effectiveness over their first several years. There is always some turnover of employees, but if the workforce becomes disproportionately inexperienced, then taxpayer compliance would likely suffer somewhat as a result. However, it is impossible to know how big an impact workforce turnover might have on the tax gap.

13. What is the IRS doing to retain experienced employees eligible for retirement?

Answer:

We identify retention as an important IRS objective in the Human Capital Strategic Plan (HCSP) for 2005–2009. HCSP Goal 2: Increase Employee Proficiency and Engagement to Enhance Tax Law Compliance states, "This goal targets our efforts in training, retention and employee engagement. Properly executed, the planned efforts should ensure a highly productive and engaged workforce able to accomplish the mission of the Service." The HCSP also identifies our desired future state as, "an agency that retains talented people who want to work and can excel in a culture of high performance, empowerment and a quality work environment."

We are updating the Human Capital Strategic Implementation Plan (HCSIP) to include a Retention Program which:

- Identifies targeted occupations, skill sets and positions upon which retention efforts should be focused;
- Identifies a wide range of retention tools and establishes consistent and objective standards for their use;
- Is monitored and evaluated to ensure relevance to existing Service needs and objectives;
- Is closely linked to our Competency Based Workforce initiatives; and
- Is integrated with all recruitment, hiring, performance management, compensation and transition programs and initiatives

We are developing a Servicewide Retention Plan/Strategy. This Plan will specify strategies for addressing the need to mitigate the potential retirement impact on Mission Critical Occupations. We have assigned a Retention Program manager along with contractor support to identify appropriate retention strategies and options for use Servicewide. Development of this Retention Strategy is a collaborative effort involving business unit stakeholders to ensure that the plan is in alignment with all IRS strategic business and human capital goals and requirements. Benchmarking efforts with other agencies, including the Office of Personnel Management (OPM), are underway. Each IRS business unit has completed some level of analysis of its retirement related attrition rate to formulate hiring and recruitment projections.

One important feature of any viable retention strategy is use of programs pointed toward improvement in the area of employee engagement. While monetary incentives like those granted in the Workplace Flexibilities Act are useful tools, they may not be sufficient without a variety of other options. We have employed some limited uses of monetary retention tools (i.e. retention and relocation bonuses). In FY 2005 and 2006, the IRS used the Workplace Flexibilities Act authority to grant 36 Retention Incentives. The IRS also has a long history of addressing employee needs through our Employee Assistance Program (EAP), benefits programs, alternate work schedules, part-time employment and other work-life programs. We are expanding existing programs such as telework arrangements. For many years, the IRS has contracted with Gallup to conduct an annual all-employee survey. We use survey data results to develop strategies and management practices targeted toward improved

employee engagement leading to improved retention rates. In addition, the Service is exploring other methods for better predicting attrition through retirement, and thereby developing appropriate activities to mitigate the impact of these retirements on our mission.

14. Describe the IRS's plans to transfer knowledge, skills and abilities from experienced workers to new workers, and to hire workers to replace employees who retire.

Answer:

The IRS has several new-hire training programs designed to transfer knowledge from seasoned employees to those who are new to the Service and/or the specific work. These training programs include, but are not limited to, on-the-job-training provided by current IRS employees with extensive experience in their position. Additionally, the IRS is recruiting interns as a method of bringing in and growing new talent for the Service. Our intern programs enable us the flexibility to provide developmental rotations to various functions within Operating Divisions and/or Service-wide.

We are making extensive use of re-employed annuitants by bringing them back to assist in training and transfer of knowledge for frontline technical positions such as revenue officers and revenue agents.

Continued professional education is provided on an on-going basis for IRS employees in specific mission critical occupations. This training is designed to ensure the competence of these employees as the work changes and they progress in their careers.

Retirement eligibility continues to be an issue, requiring the IRS to focus on the need for succession planning. Most at risk are leadership positions where workforce data demonstrated high retirement-eligibility rates. The IRS currently has several leadership development and readiness programs in place to address this issue. During FY06 we have embarked on a renewal of the IRS succession program to improve its scope, usability, and participation.

15. The Committee has requested Treasury and the IRS to submit a credible, comprehensive plan by September 30, 2006 to close the tax gap.

    a. To what extent will having a tax gap plan help to close the gap?

Answer:

A comprehensive plan can help to build consensus within the Administration and Congress concerning the key elements, to improve voluntary compliance as much as possible.

    b. Are Treasury and the IRS capable of developing a credible and comprehensive plan by September 30, 2006?

Answer:

The IRS and Treasury are capable of developing such a plan. The plan needs to be credible and cover all the key elements. It will undoubtedly become more detailed over time.

c. Describe what such a plan should look like, for example, what priorities, goals, benchmarks and measures do you think should be included in a tax gap plan? Discuss the appropriate allocation of resources among service, enforcement and technology as part of your response.

Answer:

At this point it would be premature to discuss the outlines or details of such a plan, since it is still under development.

d. To what extent can existing IRS strategic and action plans regularly prepared by operating divisions and other functions be used toward developing a comprehensive tax gap plan?

Answer:

The plans the operating divisions and functions prepare can help identify what can be done in the short term, and point toward longer term needs.

e. To what extent can recommendations from the IRS Oversight Board, the National Taxpayer Advocate, the Government Accountability Office, the Treasury Inspector General for Tax Administration, the National Treasury Employees Union and non-governmental stakeholders be used toward developing a comprehensive tax gap plan?

Answer:

Recommendations by stakeholders and oversight bodies will help inform the details of the plan.

16. Please provide the results of the most recent "TIPS" (Trends, Issues, Problems) reports for each IRS operating division and major function.

Answer:

Highlighted below are the corporate Trends, Issues and Problems (TIPS) affecting the short and long term strategic direction of the Internal Revenue Service.

Service

- Needs of individual taxpayers as part of the overall management of the portfolio of services and delivery channels, as well as reduction in burden
    - Number of new filers expected to increase 7.5% over next six years
    - Usage of the Internet for banking, online bill payment, and shopping expected to increased
    - Number of immigrants for whom English is not the primary language expected to increase
    - Changes in the tax law
- Needs of large corporate taxpayers (entities with assets greater than $10 million) in providing service and published guidance in a timely and efficient manner
    - Overall filings are expected to increase 10% by FY2007
    - Expand electronic filing.
    - Improve communication and timeliness of published guidance for the large corporate taxpayer including changes in tax laws.
- Demand for electronic products and services continues and increases
    - Increase in number of taxpayers who use a home computer to file tax returns; increase in use of paid preparers
    - Potential to expand access to e-Services
- Outreach and education activities increasing
- Preventive and corrective actions to reduce IRS vulnerability to identity theft
- Shift to defined-contribution retirement plans creates new needs
- Maximizing the impact of criminal enforcement through education and outreach

Enforcement

- Improvement in enforcement programs may reduce the risks on non-compliance, thereby reducing the tax gap
    - Improve processes to address customer satisfaction and to influence taxpayer behavior
    - Emphasize compliance treatments in "real time" to reduce burden of the taxpayer and efficiently utilize resources
    - Expand and improve ability to identify the highest risks to deter non-compliance

  - Leverage overall trends in Internet usage to provide Compliance with another option for balance-due taxpayers to interact with the IRS to pay taxes and view their accounts
  - Explore other methods for locating telephone numbers because increasing cell phone usage could make it more difficult to reach balance-due customers

- Improvement of attitudes towards compliance: Americans may be less tolerant towards cheating, but the rate of compliance for self-employed individuals remains below 50 percent
- Identification, evaluation and address of compliance risks associated with changing taxpayer business models and differences in taxpayer behavior
- Evolution of complex business structures and transactions which are multinational, multi-tiered, etc.
- Globalization (multinational companies/outsourcing)

  - Substantial international operation
  - Minimization of tax and maximization of cost savings

- Growth of E-commerce in online retail sales, making it difficult to track the earnings of Internet businesses; advances in technology increase the opportunity for money laundering and terrorist financing
- Escalation in consumer debt and bankruptcy rates, with credit card debt as the biggest cause of consumer bankruptcies and housing debt the largest contributor to household debt
- Improvement of financial reporting and transparency to deter non-compliance and to identify risks
- Persistence of abusive transactions and other compliance risks, which are major contributors to the tax gap
- Balance of compliance and outreach activities to enhance delivery of EITC initiatives and ensure delivery of the Health Coverage Tax Credit
- Maintenance of focus on legal source tax investigations, partnering with IRS Operating Divisions to deploy a successful Fraud Referral Program
- Effective relationships with the Department of Treasury, Department of Justice, and other law enforcement partners to combat corporate fraud, terrorism, other critical national law enforcement priorities, and enhance Bank Secrecy Act compliance
- Increasing the efficiency of criminal investigations through improvements in business systems and the reduction of investigative cycle time

Modernization

- Aging workforce and projected number of retirements in leadership levels creates a loss of experienced workforce, challenging the IRS' ability to meet expectations of external customers

- Changing nature of needed skills as accounting skills alone are now insufficient; new competency areas require skills associated with international, technology, and financial products.
- Federal employee salary and benefits changes and their impact on IRS retention and recruitment goals
- Leveraging new technology and reengineering business processes to maximize delivery of new business services
- Data availability, integration and utilization – Improve data and advanced technology to provide opportunities for business changes, save resources and increase performance
- Limited information available on taxpayer returns due to either the nature of the information returns filed or to incomplete data transcription
    - Information is distributed among many unlinked databases
    - Data not stored in a format that is readily accessible to most users; the number of staff with advanced analytical and statistical abilities is limited

Cross-Cutting Issues

- Tax reform and its potential impact on the IRS

17. Please provide the most recent Strategic Action Plans for each IRS operating division and major function.

Answer:

Please refer to the attachments labeled "Appendix" at the end of this document. Because the Plans for the Wage and Investment Operating Division, the Tax Exempt and Government Entities Operating Division, the Large and Mid-sized Business Operating Division, and Agency-wide Shared Services Division contain pre-decisional budget information, we are prohibited by OMB Circular A-11 from releasing those documents.

18. Provide examples of instances when the Treasury and the IRS have developed plans in response to unanticipated circumstances or legislation containing effective dates very soon after the date of enactment.

Answer:

Developing plans in response to unanticipated circumstances and legislation containing nearly immediate effective dates is ongoing at the IRS. When legislation or unanticipated circumstances occur, a key group of individuals representing every function within the Service meets to determine options for timely implementation. This group determines the necessary actions and impediments, as well as alternative solutions to the impediments. This group begins implementation efforts and reports to the Hill if there are going to be any delays in completing the process. In the past

2½ years, there have been 24 laws enacted that directly affect the IRS. To administer these laws, the Service implemented over 635 provisions requiring no less than 7500 IRS actions. Most of these 24 laws included effective dates on or very soon after date of enactment for ten percent or more of the provisions.

Two significant examples of quick responses from the IRS in providing tax relief to taxpayers, both before and after the Congress enacted legislation, occurred after September 11, 2001 and after the hurricanes in the summer of 2005. Our recent disaster assistance effort is an excellent example of how we react to the immediate needs of taxpayers. Following the Hurricane Katrina disaster, we took many affirmative steps to extend relief and provide needed tax-related guidance to taxpayers in the disaster area.

- We granted filing and payment relief to all affected taxpayers, including abatement of interest and late filing, late payment, or failure to deposit penalties.
- We established a dedicated toll free disaster telephone number to provide hurricane victims with help on tax issues.
- We developed Publication 4492, "Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma," which highlights important information for individuals and businesses.
- We partnered with other government agencies and tax professional organizations, including the American Institute of Certified Public Accountants (AICPA) and the American Bar Association (ABA), to provide assistance to taxpayers at local disaster relief centers and to expedite income verification for disaster loans and unemployment benefits.
- We extended the deadline for certain employee benefit plans to make minimum funding contributions or to apply for waivers, allowed retirement plan participants affected by the disaster to use, streamlined loan procedures and liberalized hardship distribution rules for certain retirement plans.
- We postponed the deadline for making an election to deduct in the preceding taxable year certain losses attributable to Hurricanes Katrina, Rita and Wilma.
- We joined a broad coalition of business associations to announce a partnership aimed at educating the nation's employers about a leave-donation program benefiting hurricane victims.
- We actively provided outreach to victims to inform them of important provisions affecting them, including a special section on irs.gov for providing information on new disaster tax laws and resources available for hurricane victims.

We have successfully adjusted our systems and processes to mitigate negative impact on taxpayers in response to unanticipated circumstances and legislation containing effective dates. However, when legislation is enacted or unanticipated events occur within the last quarter of the calendar year or very close to the beginning of a filing season, such as the Gulf Opportunity Zone Act of 2005 enacted on 12/21/2005, there is a chance of a delay and greater taxpayer confusion in some aspects of the filing season. This delay is not necessarily due to IRS systems and operations alone, but because of all of the private sector parties involved in tax return filing, such as tax practitioners, commercial printers, tax software developers and electronic return

transmitters. These parties also need time to change their products and services to reflect new law.

19. To what extent do delays in issuing regulations or other guidance, or delays in deciding a legal position on an issue, impact the tax gap? Comment on the appropriate nexus between expedient tax administration and the "right" legal answer to a tax issue, e.g., is it preferable to issue guidance more quickly that meets the needs of 99% of taxpayers rather than deferring guidance for an extended time in order to address the remaining 1% of taxpayers with unique or unusual circumstances?

Answer:

A significant reason the tax gap exists is that the complexity of the tax law prevents even well-meaning taxpayers from understanding and complying with their obligations. Complexity also creates opportunities for those who seek to avoid their obligations or those inclined to take aggressive positions in their tax returns. The guidance process is an important element in addressing complexity as a root cause of the tax gap. When guidance is issued interpreting ambiguous provisions in the law, taxpayers are less likely to take aggressive return positions and more likely to find these positions ultimately disallowed by the IRS and the courts.

While we believe a lack of guidance has a negative effect on compliance and the tax gap, it is difficult to determine with certainty the extent of the effect; therefore, the IRS strives to issue clear and coherent guidance as rapidly as possible. There are, however, many factors that can cause delay. Even when issues are well-understood, finding the proper legal and administrative approaches is usually a complex and time-consuming process. These issues often can only be addressed by a careful, thoughtful, systematic approach by a team of knowledgeable people. We strive to find the correct balance between issuing guidance rapidly that addresses the needs of the majority of taxpayers and the need to address complex and unique taxpayer circumstances.

The pace of issuing guidance is further driven by competing demands on the resources available to the Treasury Department and the IRS. Modifications to the process of drafting and developing guidance have helped to increase the pace at which guidance is issued.

20. The National Taxpayer Advocate testified that examiners participating in the IRS's National Research Program reported that only 3% of the issues resulting in a change in tax liability were the result of "deliberate or intentional" acts, 27% of adjusted issues were identified as computational errors, and 67% were reported to be inadvertent mistakes.

    a. To what extent are the examiners' figures reliable?

Answer:

An understanding of these results requires an understanding of how the IRS compiled the data. The NRP examiners assigned reason codes to each adjustment that they made. The reasons that they assigned these codes depended on several factors, such as how the taxpayer characterized the misreporting, the amount involved, and the standards for whether or not penalties should be assessed or fraud was involved. Ultimately, the reason recorded reflected the examiner's judgment; in most cases there is no objective way to determine the taxpayer's original motivation, and the examiners gave taxpayers the benefit of the doubt. For example, if the taxpayer intentionally overstates cash contributions, and claims to the examiner that he or she lost his or her receipts, it is impossible for the examiner to know for sure if this is the truth. Also, since the standards for when to assert a penalty are rather high, most adjustments do not carry penalties, and the NRP examiners may have translated that to mean that such adjustments should be characterized as inadvertent.

There are several reasons why we suspect that a sizeable amount of misreporting is not inadvertent:

(1) NRP, like the Taxpayer Compliance Measurement Program (TCMP), shows that the overwhelming majority of all errors (both in dollars and in frequency) are associated with underreporting. One would expect that truly inadvertent or careless mistakes would be made roughly equally in both directions: overreporting and underreporting. In reality, the total amount of understated tax is about 50 times the amount of overstated tax.

(2) Several statistical studies have suggested (and most observers agree) that the indirect effect of audits and other enforcement activities can be quite significant, in some instances. That effect would happen only if people are making compliance choices that can be deterred by enforcement actions. You would not expect to observe this effect if most noncompliance is unintentional.

(3) Several studies have confirmed that the NRP (like the TCMP) auditors cannot detect all unreported income, much of which is concentrated in the business income area. Since auditors do a good job of verifying business expenses that taxpayers do claim (for which the burden of proof is on the taxpayer), the undetected unreported net income is associated mostly with understated gross receipts. It does not seem reasonable to suggest that the bulk of understated gross receipts is omitted inadvertently.

(4) Finally, underreporting is strongly and inversely related to how "visible" the income or offset is to the IRS; information reporting and withholding promote very high compliance, while their absence promotes very high degrees of underreporting. Information reporting accomplishes this in two ways: both as a deterrent toward those who would otherwise understate their tax deliberately, and as an aid to compliant taxpayers (helping them to know what

to report). As the chart displayed at the hearing indicates, there is a much stronger bias to underreport when the income is less visible.

b. Dr. Mazur and Mr. Brostek commented that it was difficult to tell whether errors that studies had classified as simple mistakes were truly inadvertent. Please provide examples of studies that demonstrate this point.

Answer:

See the answer to part (a) above.

c. What factors could influence an examiner's characterization of the causes of an adjustment to an issue?

Answer:

See the answer to part (a) above.

d. What training do examiners receive to identify and characterize the causes of noncompliance?

Answer:

The 2001 NRP individual underreporting study was the first time that the IRS attempted to record reason codes for each adjustment made on a large set of tax returns. Revenue Agents assigned to examine NRP returns received training on the use of the reason codes. For more information on this training, see:

Internal Revenue Manual sec. 4.22.1-4.22.5.

The NRP individual reporting compliance study incorrectly assumed participating examiners understood the purpose and use of reason codes. NRP training for the 1120S study included a more substantive discussion of reason codes. The NRP Office and the Small Business / Self-Employed operating division are now working to refine future reason codes to reduce the bias toward describing misreporting as unintentional or inadvertent. However, we know it will be difficult to discern the motivations of taxpayers in every instance of observed non-compliance.

e. For purposes of the NRP study, provide the definitions of deliberate, intentional, and inadvertent.

Answer:

See the training materials referenced in the answer to part (d) above.

f. Please provide an example of the document completed by examiners that contains this information.

Answer:

Examiners directly entered the NRP examination results—including reason codes—into an electronic database, rather than onto a paper form. One advantage of that approach is that the system did not allow the examiners to leave the reason code field blank.

g. To what extent is an examiner required to consider penalties if he/she characterizes the cause of an adjustment to be the result of a deliberate or intentional act?

Answer:

Generally, the assignment of a reason code followed the determination of whether a penalty should be assessed. We realize it is difficult for examiners to conclusively determine if underreporting was intentional. For simplicity, we instructed the examiners to use a reason code indicating intentional misreporting if they intended to apply a penalty; however, this determination was not hard and fast.

21. Please provide a current list of all information returns that are matched to tax returns submitted to the IRS for the purpose of detecting unreported income. Identify additional information returns that will begin to be matched within the next 12 months.

Answer:

Internal Revenue Service Automated Underreporter Program Matching Process Crosswalk – TY 2005	
Individual Return Items	Related Information Return
Wages Statutory Wages Dependent Care Benefits Employer Provided Adoption Benefits Allocated Tips Advanced EIC Deferred Compensation	W-2
Gambling	W-2G
Interest Original Issue Discount Savings Bonds Treasury Bills Treasury Bonds Treasury Notes Early Withdrawal Penalty	 1099-INT 1099-OID

Dividends Capital Gains	 1099-DIV
Unemployment Compensation State and Local Tax Refunds Taxable Grants Agricultural Subsidies	 1099-G
  Retirement Plans/Contributions/Distributions	1099-R 1099-SSA 1099-RRB
Securities Sales Bartering	 1099-B
Real Estate Transactions	1099-S
Debt Cancellation	1099-C
Non-Employee Compensation Medical Payments Fishing Income Crop Insurance Other Income Rents and Royalties Payments in Lieu of Dividends Partnership/Trust and S-Corp Income Ordinary Income Real Estate Other Rentals Business Income Non-Passive Income Passive Income Section 179 Expenses Guaranteed Payments Dividends Interest Capital Gains	 1099-MISC 1065 Sch K-1 1120S Sch K-1 1041 Sch K-1
Credit Commodity Corporation Loans	1099-A
Patronage Dividends	1099-PATR
Qualified Tuition Program Payments	1099-Q
IRA, SEP or SIMPLE Deductions/Contrib	5498
Coverdell Education Savings Accounts	5498-ESA
Medical Savings Accounts	1099-MSA, 1099-SA, 5498-SA
Long-Term Care Benefits	1099-LTC
Mortgage Interest Refund of Overpaid Mortgage Interest Points Paid	 1098
Student Loan Interest deduction	1098-E
Withholding/Payments	Where Applicable

Additional information return items that will be matched within the next 12 months are:

Non-Qualified Deferred Compensation (W-2)
Alternative Trade Adjustment Assistance (1099-MISC)
Domestic Production Activity Adjustment (1099-PATR)

22. The National Taxpayer Advocate, the GAO and others have recommended a basis reporting regime to reduce noncompliance resulting from incorrectly stated basis amounts.

    a. Does the IRS have the ability to match basis amounts reported on an information return with basis amounts reported on a tax return?
    b. If the IRS lacks the ability to match basis information, provide the reasons why. Explain what actions are necessary to make such matching possible and how quickly this can be accomplished.

Answer:

Legislation requiring basis reporting on the sale of securities would have to be carefully crafted to overcome unique challenges. Generally, determining the basis of securities that taxpayers have recently purchased is straightforward, but other situations could present significant obstacles for financial institutions. For example, determining the basis of securities taxpayers purchased many years ago and where dividends or other distributions have been automatically reinvested can be complex. Calculations of basis can be further complicated by the taxpayer's choice of accounting method, wash sales, stock splits, corporate reorganizations, gifts and other factors.

Determining whether the IRS will have the ability to match the information that is required will be based on the type of information the legislation requires to be reported, and whether the various accounting methods that the taxpayer can use are aligned.

23. Dr. Mazur estimated that 7 million immigrants are on U.S. payrolls, and 75% of them pay employment taxes. Dr. Mazur indicated that the number of these individuals using stolen or false social security numbers is unknown.

    a. IRS Publication 4535 advises individuals to respond immediately to an IRS notice in the event of a tax matter resulting from identity theft. Describe the actions taken by IRS officials when the IRS is notified by an individual that his/her identity has been stolen, resulting in a tax matter. Provide applicable Internal Revenue Manual sections or other internal guidance describing these procedures.

Answer:

The context in which taxpayers commonly notify the IRS of identity theft involves instances in which the taxpayer has received a CP-2000 Notice of Proposed Adjustment for Underpayment from the IRS Automated Underreporter Unit. This notice essentially states that IRS records indicate wages earned under the subject taxpayer's Social Security Number (SSN) have gone unreported by that taxpayer. It is at this point taxpayers often discover they have been victimized by identity theft, as the attributed wages regard earnings that the taxpayer never earned.

When taxpayers receive this notice, they have the opportunity to dispute the attributed wages and work with the IRS to resolve the problem. In instances such as this, IRM 4.19.3.20.1.23 requires that the IRS send out letter 2626C which is used to verify misuse of the Social Security Number (SSN). Within that letter, the IRS requests information from taxpayers who have been victims of identity theft. Specifically, letter 2626C requests that taxpayers provide the following information which includes, but is not limited to, the following:

1. Authentication of identity by providing a copy of federal or state issued identification
2. Evidence of identity theft by providing a police report or a signed affidavit of identity theft provided by the Federal Trade Commission

The IRS then resolves the matter based on the information the taxpayer provides.

A second context in which identity theft is commonly associated with tax administration involves circumstances in which a single SSN is used for tax filing purposes by multiple individuals. Specifically, two individuals will attempt to file a tax return using the same SSN. When this occurs, the IRS will attempt to use internal research, based upon previous filing data, to determine the legitimate owner of the SSN per IRM 21.6.2.4.4. However, when our internal attempts to determine the legitimate owner of the SSN fail, the IRS must forward the SSN to the Social Security Administration (SSA) for verification of the legitimate owner. When that situation occurs, the IRS sends letter 239C to the taxpayer which advises that the IRS has contacted the SSA.

Collectively, these procedures are designed to assist taxpayers in fulfilling their tax responsibilities when there are problems associated with tax identification numbers. We are currently in the process of enhancing our internal procedures to ensure that we are deploying the most efficient process possible to address this important issue.

b. Describe the coordination between the IRS and TIGTA to determine the jurisdiction of stolen or fictitious identity cases that impact tax administration. Identify any impediments to such coordination, including IRC section 6103 disclosure issues.

Answer:

TIGTA's jurisdiction regarding identity theft related issues primarily concerns instances in which criminals "impersonate" the IRS in an effort to gain Personally Identifiable Information (PII) which is used to facilitate identity theft. The IRS and TIGTA have developed a strong collaborative relationship to combat the threat to the integrity of tax administration posed by this impersonation, which is a conduit for identity theft.

As an example, this past filing season saw a proliferation of phishing schemes and scams initiated by criminals seeking to gain PII. Phishing is defined as the act of sending an e-mail to a user falsely claiming to be an established legitimate enterprise in an attempt to scam the user into surrendering private information that will be used for identity theft.

In response to these phishing scams, the IRS's Identity Theft Program Office has worked with TIGTA, along with other internal organizations, to create a response plan. We created an inbox housed within IRS.Gov called phishing@irs.gov. Through consumer alerts disseminated through a wide variety of media outlets, the IRS informed taxpayers that it does not communicate with taxpayers via email concerning tax account issues. In addition, the IRS has asked taxpayers to forward these bogus emails to the inbox so that TIGTA can monitor, track, and destroy the emails. To date, the inbox has received approximately 10,308 phishing emails. This is an example of how collective efforts between the IRS and TIGTA have worked to protect the nation's taxpayers from the harm associated with identity theft-related scams.

It is important to note that IRS Criminal Investigations (CI), not TIGTA, has jurisdiction over cases involving specific instances of identity theft within tax administration, as such action constitutes fraudulent criminal activity. However, taxpayers will often proactively contact TIGTA when they believe they have been victimized by identity theft. When this occurs, these inquiries are referred to the Identity Theft Program Office within CI for the appropriate action.

There are no disclosure impediments resulting from IRC section 6103 because TIGTA and IRS agents are Treasury Department employees with statutory access to tax information for tax administration purposes.

c. How many stolen or fictitious SSN cases have been reported to the IRS during the last five years? How does the IRS track this figure?

Answer:

Currently, the IRS has not developed metrics to establish the precise scope of the identity theft problem as it relates to tax administration; however, it is currently engaged in an Identity Theft Risk Assessment to develop this data. The purpose of this study is to gain an understanding of the scope and impact of identity theft on tax

administration. Ultimately, the knowledge gained from this study will be used to set operational priorities and increase the effectiveness of the IRS's Identity Theft Enterprise Strategy.

d. How many stolen or fictitious SSN cases have been worked by the IRS during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.

Answer:

As previously stated, the IRS has not developed metrics to establish the precise scope of the identity theft problem as it relates to tax administration. However, Criminal Investigations has 95 cases involving identity theft under active investigation. Further, 106 cases are completed and awaiting legal review or prosecution. The average sentence received in identity theft cases is 42 months.

e. How many stolen or fictitious SSN cases have been reported to TIGTA during the last five years? How does TIGTA track these cases?

Answer:

TIGTA will respond to this question.

f. How many stolen or fictitious SSN cases have been worked by TIGTA during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.

Answer:

TIGTA will respond to this question.

g. In the event of a recurring problem, i.e., the same SSN is claimed by more than one taxpayer for more than one year, is the case worked every year or resolved for all future years?

Answer:

The IRS has a process in place which will resolve this issue for future years. The details of this process are sensitive. We would be happy to brief your staff on this program at your convenience.

h. Provide the Full Time Equivalents (FTEs) spent on ID theft cases during the last five years by the IRS and TIGTA.

Answer:

While employees in various IRS functions are involved in resolving identity theft cases, a precise quantification of FTE spent on ID theft over the past five years is not available. However, approximately one quarter of our 30 CI field offices have representatives on identity theft task forces. This number includes some field offices which have representatives in multiple judicial districts.

In addition, the IRS has established an Identity Theft Program Office whose mission is to coordinate the overall IRS policy surrounding identity theft by focusing on outreach, victim prevention, and victim assistance. This office currently has 4 FTE.

i. To what extent do staffing levels impact on the IRS's, and TIGTA's, ability to work identify theft cases?

Answer:

The Identity Theft and Assumption Deterrence Act of 1998, which amended Title 18 U.S.C. § 1028, among other things, added a new Subsection (a)(7) which expanded the jurisdiction of IRS Criminal Investigation into the Identity Theft arena. This new subsection enabled Criminal Investigation to investigate and recommend prosecution under this statute in tandem with the investigation of substantive tax and money laundering violations emanating from refund fraud and money laundering schemes.

In January 2000, Criminal Investigation provided additional guidance to its Field Offices to more effectively combat financial crimes that fall within its investigative jurisdiction. Title 18 U.S.C. § 1028 violation is not intended to be a Criminal Investigation stand-alone violation, but rather a tool to assist in enhancing the investigation of complex Questionable Return Program (QRP) and money laundering schemes.

24. Provide an analysis of the benefits and burdens on payers, payees, and the IRS, in connection with increased information reporting and withholding requirements. Include your conclusions and recommendations concerning an appropriate balance of benefits and burdens and the impact on effective tax administration.

Answer:

Information reporting helps compliant taxpayers know the correct amounts to report on their returns; it saves time and effort that would otherwise have to be spent maintaining records. Information reporting does place a burden on those who must provide the information; however, most of this information is already available in the computer systems of the payers and other affected institutions, and there are far fewer entities needing to provide such information than there are taxpayers. We can consider this kind of burden a necessity, which has been reduced over time due to the increased capability and decreased cost of computers.

Withholding can further enhance voluntary compliance when it helps taxpayers to pay their tax on time. Its cost has also been reduced by computers, particularly with the advent of electronic deposits.

Both information reporting and withholding provide the additional benefit of inducing those who would otherwise be noncompliant to file tax returns to report the correct tax liability, and to pay their tax on time. Misreporting of income (and therefore the tax gap) is inversely related to how "visible" taxable items are. Wages are subject to substantial information reporting and withholding, making them very visible and therefore misreported at approximately a one percent rate. In contrast, proprietor income, which is generally not subject to information reporting nor withholding, is misreported over 50 percent.

25. To what extent would raising public awareness of the importance of complying with tax laws impact the tax gap? Describe ways that raising public awareness could be achieved.

Answer:

Public awareness campaigns have successfully reduced carelessly started forest fires, drunk driving, smoking, and littering. The key to success in such a campaign, however, is to convince individuals that it is in their own interest to change their behavior.

26. The IRS website provides phone numbers and addresses for local IRS offices. Taxpayers are advised they can call a phone number, leave a message, and the call will be returned by the IRS within 2 business days. The Committee recently tested the level of service to taxpayers calling the IRS. Calls to 25 of these sites yielded only 18 returned phone calls, a 28% failure rate. Of the 18 responses, only one IRS caller suggested visiting the IRS website for information. The most prevalent recommendation by the IRS responders was for the caller to visit the local IRS office for assistance. IRS leadership explains proposed reductions in taxpayer assistance center hours and services are justified because of increased web services.

    a. Explain why 28% of the phone calls would not be returned.
    b. Explain the apparent disconnect between IRS leadership and front-line employees regarding the use of the IRS website as an information resource for taxpayers.

Answer:

We acknowledge that we are not always meeting the 2-business day requirement to return phone calls to taxpayers who have left messages on the local IRS phone number (referred to as the 3709 line). A TIGTA audit that is currently in draft report status has found the same deficiency. We are in the process of tightening internal

controls and establishing a monitoring process to ensure compliance with the 2-day requirement.

We encourage taxpayers to use the website as an information resource by encouraging callers to the 3709 line to seek more convenient alternatives, including both the Internet and the toll-free telephone lines. Additionally, the message recording for the 3709 line also encourages alternatives to visiting our offices in person. We plan to clarify and reinforce instructions for our employees that return the messages left by the taxpayers on the 3709 lines to ensure that we recommend the most convenient alternatives.

27. TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," found that while the IRS has increased its examination coverage rate of high-income taxpayers, the increased coverage largely is due to correspondence examinations. TIGTA reported assessments of $1.4 billion on taxpayers who failed to respond to the IRS during correspondence exams, however, 71% of these assessments remained uncollected after almost 2 years. Given these results, is it efficient to use IRS resources to conduct a correspondence exam that can be ignored by a taxpayer without apparent consequence?

Answer:

While the results presented in the TIGTA report indicate a large volume of abatements and many uncollected assessments to date, the program has resulted in approximately a $5,000 return on investment, per return. Furthermore, an important part of this program is to bring these taxpayers into compliance.

The IRS has placed significant emphasis on the portion of the tax gap attributable to high-income taxpayers. The IRS has increased face-to-face examinations by 25% from FY 2002 to 2005. Additionally, in 2003 the IRS developed a strategy to address egregious and high-risk segments of the non-filer population. This strategy included increasing our correspondence examinations of high-income taxpayers for whom there exists third-party information. High-income non-filers pose a significant threat to voluntary compliance. We attempt to engage these non-filing taxpayers by sending correspondence to the last known address and using all available data to arrive at correct assessments. If the taxpayer does not choose to engage the IRS during these examinations, the IRS must still pursue the case. Once the IRS makes an assessment, a myriad of collection opportunities arise.

28. TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," indicates that IRS management officials say they are working on a plan to better identify high-income tax returns for examination, *including placing less emphasis on non-filers.* TIGTA report #2004-30-127, "The Return Delinquency Notice Program Could Be Used More Effectively to Promote Filing Compliance and Reduce the Tax Gap," found that the number of potential individual non-filer cases increased from 6.1 million in 1994

to 8.9 million in 2001, but that IRS resources assigned to these cases had declined. TIGTA observed that the ability of the Return Delinquency Notice Program to effectively promote filing compliance has been significantly affected. TIGTA estimated at least $1 billion in taxes was foregone as a result.

a. Explain the IRS's decision to place less emphasis on high-income nonfilers in light of these TIGTA reports.

Answer:

The IRS has not placed less emphasis on high-income nonfilers; in fact, the IRS is focusing more of its resources on high-income taxpayers in general. However, the IRS does continuously adjust its resources to high areas of non-compliance where its enforcement activity would have the greatest impact.

b. What impact would deemphasizing high-income nonfilers have on tax administration and the tax gap?

Answer:

A decreased emphasis on compliance activity for high-income nonfilers may adversely affect tax administration as the IRS has a continued goal of bringing taxpayers into compliance. However, as stated above, the IRS aligns its resources consistently to impact those areas where non-compliance is higher and also to address areas of non-compliance contributing to the tax gap.

c. Why do so many high-income taxpayers ignore correspondence audits? Is this true for other taxpayer groups, as well?

Answer:

The TIGTA report focused on correspondence audits and a substantial portion of the population of taxpayers were high-income nonfilers. Nonfilers in general have a greater tendency to ignore correspondence audits as this group of taxpayers has refused to voluntarily comply with the law. It is always more difficult to bring these taxpayers into compliance than other taxpayers who file returns, but fail to properly report all income items. In general, the no response rate on correspondence audits of non-filers is greater than other taxpayers audited through the correspondence program.

d. What can the IRS do to increase taxpayer response to correspondence audits?

Answer:

The IRS consistently engages in educational outreach to taxpayers, which should affect taxpayer responses to any audit activity by the IRS. A combination of outreach

activity and increased enforcement activity by the IRS should assist the increase of taxpayer responses to correspondence audits.

e. How can the IRS collect tax deficiencies resulting from correspondence audits sooner?

Answer:

The IRS strives to collect all tax deficiencies resulting from correspondence audits, and all other audits, as soon as possible. However, it is important to note that the collection of liabilities arising from correspondence audits and other examinations does not begin until the taxpayer has concluded the administrative appeals process.

29. TIGTA report #2006-40-067, "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program," found that at least 47 Taxpayer Assistance Centers are understaffed. What plans does the IRS have to ensure that TACs are staffed commensurately with taxpayer needs?

Answer:

We are continuing efforts to stabilize the workforce in the Taxpayer Assistance Centers (TACs) and to position ourselves for next year's filing season. We are currently conducting a wave of hiring that is expected to produce over 300 front-line employees. This on-board level stabilizes the workforce in FY 2006 and positions us to keep all 400 TACs open and minimize taxpayer wait times in FY 2007.

30. The May 27, 2006 IRS Filing Season Data reports 3,449,641 field assistance walk-in contacts, an 11.1% decrease from 2005. Describe how this count is taken. Are taxpayers who desire services not offered by the TAC included? Are taxpayers who appear outside the hours of service or when the TAC is closed for lunch counted?

Answer:

Total Walk-ins includes the number of customers physically present in a TAC and seen by an employee. The counts include the following services offered in the TAC: Forms, Return Preparation, Tax Law Questions, Account Work/ Notices, and Other FA Contacts.

We include taxpayers seeking services not offered by the TAC if a taxpayer physically comes to a TAC and is seen by an employee. If we cannot assist the taxpayer because the service is not offered, or if they enter the TAC and are logged in by the queuing system but opt to leave prior to obtaining service, that taxpayer will be included in the walk-in contacts count.

Taxpayers who appear outside the hours of service or when the TAC is closed for lunch are not included in the walk-in contacts count. TAC offices do not have the

technological capability to capture customers who visit the TAC during non-business hours. Further, we are not aware of any walk-in customer service environment with this type of technology capability.

31. Please provide a status report of the foreign source information reporting matching test program that the Committee was briefed on earlier this year during briefings about TIGTA report #2005-30-101, "Compliance Opportunities Exist for the Internal Revenue Service to Use Foreign Source Income Data."

Answer:

The Director, International, Large and Mid-Size Business Division, established controls within the Automatic Exchange of Information Program (AEIP) that monitor the receipt and timeliness of foreign-source income data.

We could not agree to implement a pilot program to include foreign-source income documents in the domestic Information Returns Program or develop a separate matching program. Foreign-source information documents must contain Taxpayer Identification Numbers (TINs) or be processed through TIN perfection before they can be useful to Wage and Investment's Automated Under Reporter (AUR) process. Currently, over 90% of incoming documents do not contain any TINs. Also, our treaty partners do not always collect and provide us with data based on a calendar year. Delaying the AUR process to perfect TIN matching and to convert the data to a calendar year would extend audit cycle times and be prohibitive from a cost/benefit perspective. However, we continue to look for other methods of implementation of this data within our compliance programs.

The Associate Chief Counsel, International (ACCI) has advised the Director, International (LMSB) that, under current treaties, we can only disclose foreign source information to people or entities involved in the assessment, collection, enforcement, or prosecution of tax covered by the treaty. Further, these individuals or entities may use the information only for such purposes, and only for administration of a treaty-covered tax under Title 26. Thus, we cannot use information received under a tax treaty to enforce the Foreign Bank and Financial Accounts Report (FBAR) reporting obligations under Title 31. With Treasury, we continue to believe that a general change in policy would produce little benefit while having significant negative consequences. We continue to explore whether a targeted provision could allow effective use of treaty exchanged information in non-tax cases without violating long-standing treaty policy or raising significant privacy concerns.

32. To what extent do concerns about the tax gap impact on the IRS's initial budget request to Treasury? For example, when preparing its budget request, does the IRS identify the scope of the tax gap problem and ask for resources commensurate with the size of the gap? Does the size of the tax gap influence the "pass backs" from Treasury and OMB?

Answer:

Neither this Administration, nor its predecessors discuss pre-decisional information on the development President's Budget. However, I can report that the extent of the tax gap is just one factor the IRS considers when submitting a budget request to Treasury. The Service must first identify how much funding is needed to support existing core programs and new priorities, what productivity savings might be generated to offset these needs, and how base resources might be better allocated and/or reassigned to improve IRS operations.

Business Units review their operations and resource usage with the Commissioner throughout the year, seeking to optimize Service operations. This process does not just focus on the tax gap; it seeks to maintain a balance between enforcement and taxpayer service. This approach is supported by the IRS strategic plan and the "equation" that Service plus Enforcement equals Compliance. Both objectives are essential to ensure a fair tax administration system that provides the critical balance between protecting taxpayer rights and ensuring every American pays his or her fair share. The IRS believes that all activities—both taxpayer service and enforcement—contribute in a positive manner—directly and indirectly—on overall voluntary compliance, which reduces the tax gap.

Given that enforcement and late payments often take many years to be collected, we estimate that for the 2001 tax year, direct IRS enforcement activities, in combination with late payments, will reduce the gross tax gap from $345 billion to a net tax gap of $290 billion. Other factors that influence the IRS's ability to address the tax gap include the need to develop and implement (a) legislative proposals or administrative changes that facilitate effective and efficient tax law enforcement; and, (b) enhanced information technology systems and infrastructure that support IRS operations.

33. Dr. Mazur stated in his testimony that "most countries would be thrilled to have a voluntary compliance rate of almost 84 percent." Please provide the voluntary compliance rates for countries in the European Union and/or the G-8. To the extent possible, present the rates in a format that is comparable to US tax gap measurements, e.g., "apples to apples", including breakdowns by the type of taxpayer and the type of tax.

Answer:

Most other countries do not estimate a concept analogous to the tax gap or voluntary compliance rates at all, making direct comparisons impossible. (Some have more limited compliance measures than the U.S., but none produce comparable estimates.) The comment was based on the general consensus among tax administrators (e.g., through such organizations as the OECD) based on their enforcement experience.

34. Provide estimates of the average return on investment (ROI) for each additional dollar appropriated to the IRS for enforcement (relative to the FY 2006 appropriation). Please include both the direct and indirect effects on revenues. Indirect effects should

include both the impact on taxpayers whose returns or parts of returns are not examined, and the impact in subsequent years on taxpayers whose returns or parts of returns are examined.

Answer:

The enforcement initiatives contained in the FY07 budget request provide an average direct return on investment, when fully operational, of between 3:1 and 4:1. This return includes dollars we expect to collect from taxpayers subject to enforcement activity. The cost of the initiatives includes the direct cost of enforcement staff, plus indirect support costs, such as IT equipment, rent, and required support staff. The average direct return on investment masks a wide range of estimated returns, with more capital-intensive initiatives generally seeing a significantly larger direct return on investment, because costly staff resources are more heavily leveraged by technology investments.

While some third-party research studies have estimated the indirect compliance effect of certain types of enforcement activities could be as high as ten times the direct effect, such estimates should be treated with caution because they are based on historical data and the relationships may have changed over time. Since the net direct effects are very productive at current levels of enforcement, we generally need not consider positive indirect effects to justify or allocate additional enforcement resources.

35. Provide estimates of the average return on investment (ROI) for each additional dollar appropriated to the IRS for taxpayer service (relative to the FY 2006 appropriation). Please include both the direct and indirect effects on revenues. Indirect effects should include both the impact (if any) on taxpayers not receiving service and the impact in subsequent years on taxpayers who receive service.

Answer:

We do not have estimates of either the marginal direct revenue effect or of the marginal indirect revenue effect of taxpayer service. We need substantial amounts of research in this area to understand the relationship between service levels and overall compliance.

36. Provide estimates of the average return on investment (ROI) for each additional dollar appropriated to the IRS for any purpose (relative to the FY 2006 appropriation). Please include both the direct and indirect effects on revenues. Indirect effects should include both the impact on taxpayers whose returns or parts of returns are not examined or who do not receive service, and the impact in subsequent years on taxpayers whose returns or parts of returns are examined or who do receive service.

Answer:

As noted above, we only have estimates of the marginal direct revenue effect or of the marginal indirect revenue effect of enforcement.

37. To what extent is it feasible for the IRS to include a "marker" on its Master File system to denote that a Form 8886 has been filed?

Answer:

Placing a "marker" or indicator on the Individual and Business Master File systems to denote that a taxpayer has filed a Form 8886 is feasible, but we could not complete the changes necessary until January 2008, the start of the filing season for 2007 tax returns. Both filing and master file areas would require changes, and possibly other areas may be affected. Currently, we have finalized changes and updates for the 2007 filing season, and are coding and preparing the changes for testing.

Costs would include a relatively small amount of IRS and contractor staff if the request is limited to just adding a Form 8886 indicator and is performed as part of the yearly updates done for tax year changes. We prioritize all changes, however, and do compete for the limited amount of resources available that are capable of making such an addition to the systems.

38. TIGTA report #2006-50-077, "Some Concerns Remain about the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections," found that assumptions and methodologies used by the IRS to calculate the 2001 tax gap may be faulty. To what extent is the reliability of the IRS's estimates of the tax gap compromised by faulty assumptions and methodologies?

Answer:

Our estimates of the tax gap for Tax Year 2001 are the best that could be produced with the data available and in the time available. TIGTA's greatest concern is that we base some components of the tax gap estimates for Tax Year 2001 on compliance data for earlier years, and that the projections from the earlier years to 2001 assume compliance rates have not changed in the affected components (meaning that the gap grew in proportion to the growth in tax receipts in those components). There really are no better assumptions in the absence of new compliance data, and historical compliance trends have been quite stable, suggesting that the assumption is quite reasonable as a first approximation. TIGTA also noted that the IRS has no tax gap estimates at all in some categories. We have produced estimates—some based on fairly old data—where we believe that they are of the right order of magnitude, and have been very clear about the level of certainty to attach to a given estimate. However, we have not produced estimates where we have no reliable data. We are exploring alternative sources and methodologies for these components, much as we used Census data for our individual income tax nonfiling gap estimates. However,

most observers agree that the tax gap estimates for components for which we have no estimates are likely to be relatively small.

39. For FY 2005, please provide the following data about the IRS's Automated Collection System (ACS). TDA refers to Taxpayer Delinquent Accounts and TDI refers to Taxpayer Delinquency Investigations.

    a. Number of TDAs closed during the year, and length of time in inventory

Answer:

1.5M TDA closures (excluding TC530-39) with an average length of time to close of 33 weeks (excluding TC530-39)

    b. Number of TDAs in inventory at the end of the year, and average length of time in inventory

Answer:

1.8M TDAs in inventory and an average of 36 weeks

    c. Number of TDIs closed during the year, and length of time in inventory

Answer:

374,467 TDIs closed and an average of 30 weeks in inventory

    d. Number of TDIs in inventory at the end of the year, and average length of time in inventory

Answer:

880,959 TDIs were in the inventory at the end of the year. Because some of these cases may be carried over from previous years and others may be resolved in less than one year, it is impossible to say the average length of time in inventory. We can provide a breakout by various categories.

TDI in inventory:

Less than 6 months: 813,288
6– 9 months: 86,415
10–15 months: 209,832
16+ months: 113,486

    e. Total collections, collections per case, collections per FTE

Answer:

Total Dollars Collected – $3.6 billion
Dollars Collect per TDA taxpayer closure – $2,481
Automated Collection System (ACS) dollars collected per FTE – $1,300,132

f. Accounts written off, average length of time in inventory, dollar value of the accounts written off, and criteria used to decide whether to write-off

Answer:

We can only provide the amounts written off, as the actual number of accounts written off is not available. Write-off is generally based on the collection statute of limitations. The taxpayer can extend the normal ten-year collection period.

FY05 – $19.7B (Total tax, penalty and interest written-off)
FY06 – $13.6B (estimate based on 3 quarters FY06 data)
Source – Collection 5000-104 Reports

g. Number of incoming phone calls and the number of calls answered

Answer:

4.52M incoming calls, including automation – both BODs (ACS)
3.76M calls answered, including automation – both BODs (ACS)

h. Number of outgoing calls

Answer:

We do not track outbound calls other than the Predictive Dialer (PD). We attempted more than 912,000 PD calls in FY05.

i. To what extent do staffing levels and technological capacity impact the ability to process calls and work the accounts?

Answer:

Staffing levels have a direct relationship to our ability to process calls. Our work is taxpayer driven in the sense that we issue notices, letters and telephone messages that direct the taxpayer or third party to contact us at a variety of toll free telephone numbers. We must then anticipate how many of the customers receiving these various contacts will place a call to the IRS. We must also project how long it will take to handle those incoming calls and how many employees will be needed to process the incoming calls.

Technology also plays an important role in the proper routing and handling of incoming calls. For example, the IRS Automated Collection System telephone product line is used to route calls based on geographic location to individual call sites. This process could have resulted in inconsistencies in how long the customer waited to have their call answered by an assistor, depending on call demand. We recently transitioned ACS to an Enterprise Queue (EQ) platform for handling incoming calls. EQ looks at all ACS contact representatives across the country that are available to take incoming phone calls and routes the call to the next available assistor. This process has resulted in calls being answered more efficiently and has reduced the amount of time the customer must wait for the call to be answered. We will be moving Accounts Management EQ in October 2006 and transition other product lines over the next several years.

j. Number of cases in the Collection Queue, average length of time in inventory, and the dollar value in the queue

Answer:

Queue TDA Taxpayer Cases – 607,114
Dollar Amount in Queue – $20,292,697,711
Average Length of Time for Queue TDA Closure – 56 weeks

*Collection statute runs 10 years and can be extended with consent from the taxpayer.

k. Queue accounts written off, average length of time in inventory, dollar value of the accounts written off, and criteria used to decide whether to write-off

Answer:

We can only provide the amounts, as the actual number of accounts written off is not available. Write-off is based on the collection statute, which runs for 10 years. The taxpayer can extend the collection period.

FY05 – $19.7B (Total tax, penalty and interest written-off)
FY06 – $13.6B (estimate based on 3 quarters FY06 data)
Source – Collection 5000-104 Report s

l. To what extent will the private debt collectors be assigned inventory from ACS and the Queue?

Answer:

The IRS expects to assign approximately 100,000 accounts to the three Private Collection Agencies (PCAs) in the first year of this program (September 2006 thru August 2007). The cases we will place with PCAs will be relatively simple accounts and inventory not currently worked by either ACS or Field Collection staff (i.e.

revenue officers). About one-third of the potential new inventory that will be available for PCA assignment is from the Queue.

From Senator Kerry:

1. What concrete steps should be taken to improve voluntary compliance?

Answer:

In general, improving voluntary compliance will require a combination of tax law simplification, additional third-party information reporting in carefully targeted areas, improved enforcement, and enhanced taxpayer service.

2. Is the underreporting of income the biggest contributor to the tax gap and if so, are there ways to significantly improve reporting that are not burdensome and costly for small businesses?

Answer:

Yes. The underreporting of income for the individual income tax alone accounts for about 48 percent ($165 billion) of the entire tax gap of $345 billion for TY2001. About two-thirds of that ($109 billion) comes from the underreporting of business income by individuals (e.g., sole proprietor income, farm income, partnership income, etc.). The most important reason for the underreporting of income is the lack of "visibility" of the income to the IRS—that is, the lack of third-party information reporting or withholding. The Net Misreporting Percentage of wages, for example, is only 1.2 percent because wages are subject to substantially comprehensive information reporting and withholding. However, the Net Misreporting Percentage of sole proprietor income is greater than 50 percent because it is subject to very little information reporting.

We have already implemented most of the opportunities for information reporting and withholding that are the easiest to implement. The key to keeping the cost and burden of new requirements low is to focus on requirements that would be implemented by only a relatively few large businesses; the requirements should help to make income more visible, but place little, if any, burden on the sole proprietors themselves. Proposals contained in the President's FY2007 Budget Proposal concerning credit card payments and government contractors, for example, have tried to follow this strategy.

3. In a new report, the Treasury Inspector General for Tax Administration has criticized lapses in IRS security measures to protect against unauthorized access to returns. What is being done to address this?

Answer:

The IRS takes security and privacy responsibilities very seriously and we agree with the need to continue our improvement efforts against unauthorized access to tax returns. The Chief, Mission Assurance and Security Services (MA&SS) and the Chief Information Officer (CIO) partnered to develop an on-line, access-compliance monitoring and reporting system to replace the cumbersome paper process. The Integrated Data Retrieval System On-line Reporting System (IORS) provides a set of notices and reports designed to provide early detection of potential problems and trends in intentional, unauthorized access by employees, and tracks managers' review and investigation of these reports.

The IRS continues to pursue enterprise implementation of the IORS initiative. Deputy Commissioners will require IORS compliance statistics to be included in the quarterly operational reviews and address any noncompliance or enforcement issues. As well, the Chief, MA&SS and the CIO are coordinating an IRS review to prioritize IORS enhancements/weakness resolution requirements and re-compete the contract for the system development and upgrade. With this proactive approach we are accomplishing our goal of ensuring security and privacy of all private Taxpayer information.

4. What percent and amount of the tax gap can be contributed to the earned income tax credit (EITC)? What percent of audits is conducted on EITC filers?

Answer:

We estimate that under 5 percent of the TY2001 $345 billion tax gap is attributable to the Earned Income Tax Credit. This tax gap estimate is generally consistent with the estimated improper payments of the EITC of between $9.6 and $11.4 billion for FY2005. In Fiscal Year 2005, we selected a total of 521,872 returns for examination on the basis of an EITC claim. This segment was 39 percent of the 1.33 million examinations closed that year (source of audit data: *Internal Revenue Service 2005 Data Book*, Table 10). The IRS costs associated with funding all enforcement and error reduction initiatives for the EITC amounted to $164 million in FY2005, or 3.75 percent of all enforcement spending and 1.6 percent of the entire IRS budget (source: *Internal Revenue Service 2005 Data Book*, Table 30). Prior to FY2005, Congress appropriated these EITC-related funds separately from the rest of the IRS budget.

5. In a new report, the Treasury Inspector General for Tax Administration indicates that 70 percent of the assessments on high-income taxpayers have not been collected. Why has this happened and what can be done to improve collection rates?

Answer:

The Treasury Inspector General for Tax Administration (TIGTA) report (#2006-30-105) focused specifically on the use of correspondence audits to increase compliance coverage for high-income taxpayers. Therefore, the data cited in that report was

specifically related to this specific sub-set of high income taxpayers. Non-compliant high-income taxpayers are a compliance risk as they represent taxpayers with significant amounts of income reported by third parties through information documents, yet they either haven't filed at all or failed to report all their income. We do collect a significant amount from these assessments. Using the data quoted in the report, the IRS collected approximately $900M within the first 608 days from an examination's recommended tax change (roughly 45%). Once the administrative appeals process is concluded, some assessments are reduced. Additionally, assessments are reduced pursuant to claims filed by taxpayers to correct their tax liability. Furthermore, it should also be noted, that correspondence audits are used to try and bring non-filing taxpayers into compliance.

Because our collection system looks at balances due versus income of taxpayers, we cannot draw a direct correlation to the data above. However, while in 2004 the IRS assessed $2.1B in additional tax on high income taxpayers (TIGTA report # 2006-30-105), the IRS has collected approximately $1.3B on large dollar assessments, those greater than $100K, through July of this year. While these do not necessarily correspond to high-income taxpayers, they do reflect an emphasis on larger assessments.

6. What percent of audits are conducted on high-income taxpayers?

Answer:

The IRS has been working to increase its enforcement activity in the area of high-income taxpayers. As a result, its audit coverage of high-income taxpayers has increased from 0.96% to 1.57% from years 2000 through 2005.

Appendix

1. Small Business/Self-Employed Strategic Plans
2. Modernization and Information Technology Strategic Plan
3. Mission Assurance and Security Services Strategic Plan
4. Criminal Investigation Strategic Plan
5. Human Capital Strategic Implementation Plan

FY 2006 – FY 2007 Plan

August 2006

Letter from the Commissioner

The Small Business/Self Employed Division is committed to delivering valued services and programs that educate and assist our small business and self-employed customers in understanding and complying with the tax laws. Whether we are providing service through education, outreach, or burden reduction, or addressing noncompliance through our enforcement efforts, our fundamental aim is to help all taxpayers comply with the tax laws and to ensure that these laws are applied fairly to all. Sustaining compliance requires a balance between service and enforcement, and SB/SE is committed to maintaining this balance for our taxpayer community.

SB/SE employees can take great pride in all that we accomplished in FY 2005. We continue to see significant improvements in customer satisfaction, employee engagement, and business results – the Service's three balanced measures. These achievements would not have been possible without teamwork and the dedication of everyone in SB/SE.

With the largest enforcement presence in the IRS, SB/SE has a critical role to play in ensuring the accomplishment of the IRS corporate goals of enhancing enforcement of the tax law, improving taxpayer service, and modernizing the IRS through its people, processes and technology. SB/SE's taxpayers account for the largest part of the tax gap. We must continue to work together as an organization to close the tax gap, improve our processes, and find ways to be even more efficient and effective at what we do.

Just as the IRS Strategic Plan sets the direction and goals for the Service as a whole and a framework for Business Divisions' plans, our own SB/SE plan establishes SB/SE's strategies and priorities for FY 2006 and FY 2007. It will guide us in meeting the needs of our taxpayers, in meeting emerging challenges, and in supporting the accomplishment of the IRS corporate goals.

It is vitally important that we, as an organization, stay focused on our priorities and continue to explore every option available to foster an organization and a workforce committed to customer satisfaction and sustained business improvement.

Sincerely,

Kevin M. Brown
Commissioner, Small Business/Self-Employed Division

SB/SE Plan
FY 2006 and FY 2007

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SB/SE Plan
FY 2006 and FY 2007

This plan reflects SB/SE efforts to identify, analyze and address the essential and significant issues facing the SB/SE taxpayer customer segment. The basic thrust of this plan is reducing the tax gap and improving compliance in all three tax gap areas. The priorities identified in this plan both emphasize and sharpen SB/SE's focus on the challenges that we will face in the coming years.

I. ABOUT US: MISSION, ORGANIZATION AND CUSTOMER BASE

The mission of the Small Business/Self-Employed (SB/SE) Division is to provide SB/SE customers top-quality service by educating and informing them of their tax obligations, developing educational products and services, and helping them understand and comply with applicable laws. Additionally, we protect the public interest by applying the tax law with integrity and fairness to all.

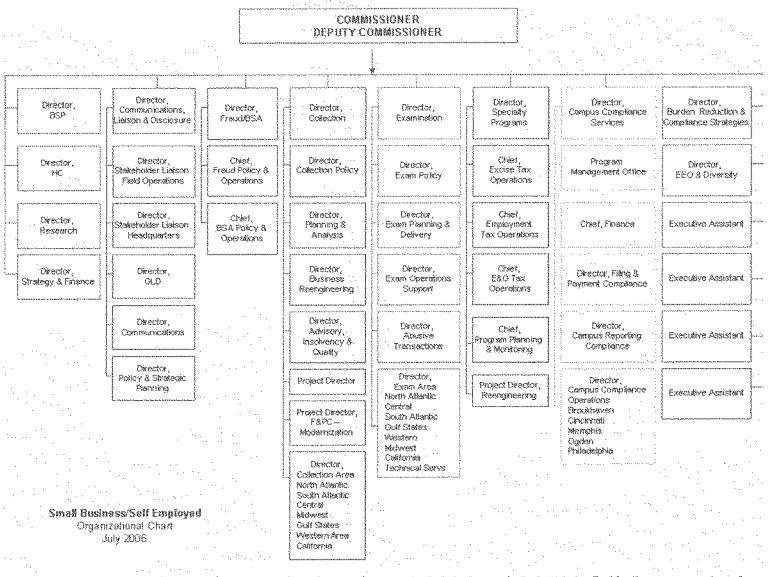
The SB/SE operating division currently has approximately 27,000 employees who serve 55 million taxpayers. While SB/SE serves one-third of the overall taxpayer base, three-quarters of the tax gap comes from this group.

Among those served are about nine million small businesses, including corporations and partnerships with assets of $10 million or less. While small businesses face many of the same tax issues as large corporations, many do so without the assistance of tax professionals on staff. Their tax compliance issues often stem from a lack of understanding of tax law requirements, inadequate accounting practices and cash flow problems.

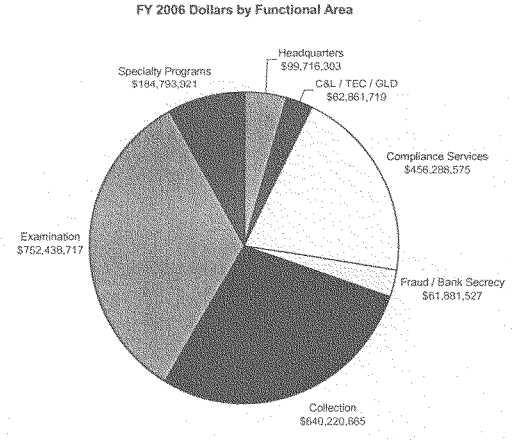
SB/SE also serves approximately 40 million self-employed and supplemental income earners who are similar to wage and investment taxpayers, but whose tax issues are often more complex. They often have substantially higher incomes and file twice the number of forms and schedules, requiring more time to prepare taxes, a greater reliance on paid tax preparers and more IRS expertise. Many are not subject to third-party reporting of income and withholding. Still other taxpayers served by SB/SE are filers of employment, excise, estate, gift, and fiduciary tax returns.

SB/SE has the largest compliance and enforcement presence in the Service with 94 percent of its resources allocated to compliance activities. SB/SE's compliance and enforcement activities are organized by program concentration: Examination, Collection, Specialty Programs, Fraud/Bank Secrecy Act (BSA) and Campus Compliance Services

(CCS). SB/SE also includes the offices of Burden Reduction and Compliance Strategies, Communications, Liaison and Disclosure (CLD), Business Systems Planning (BSP), Human Capital, Research, Strategy & Finance, and EEO and Diversity.



The SB/SE Division has a $2.27B budget for FY 2006 and 26,530 full time equivalents (FTE). The budget allocations for FY 2006 for SB/SE's primary compliance functions, CLD and Headquarters operations are as follow:



SB/SE enforcement activities are aligned along functional examination, collection, specialty tax and compliance services/campus lines. This structure brings a more focused approach for ensuring program delivery, making the best use of existing knowledge and experience, allowing for enhanced end-to-end accountability, and leveraging the specialized expertise of our workforce. Each organization is responsible for the following activities:

Examination: This office is responsible for all field and office examinations which include cases involving abusive transactions, flow-throughs, high-income taxpayers and S-Corps.

Collection: This office is responsible for all field collection activities which involve collecting delinquent taxes and securing delinquent tax returns, including the use of enforcement tools when appropriate.

Campus Compliance Services: This office is responsible for most of the compliance operations, both examination and collection activities, conducted in the IRS Campuses. Some of the programs include Correspondence Exam, Automated Underreporter (AUR), Automated Collection System (ACS), Centralized Case Processing and Centralized Offer-in-Compromise.

Specialty Programs: This office is responsible for all compliance and enforcement activities surrounding Excise, Employment, and Estate and Gift Tax.

Fraud/BSA: This office is responsible for coordinating the establishment of Service-wide fraud strategies, policies, and procedures and providing Fraud Referral Program coordination for all operating divisions. In addition, Bank Secrecy Act examinations are conducted to detect and deter money laundering, terrorist financing, and other financial crimes.

II. HOW WE SUPPORT IRS GOALS AND OBJECTIVES - LINKAGE TO IRS STRATEGIC PLAN

In June 2004, the IRS Strategic Plan was published. The IRS Strategic Plan sets forth the strategic priorities, goals and direction for the IRS. The strategic goals established to guide the future direction of the IRS are:

- Improve Taxpayer Service
- Enhance Enforcement of the Tax Law
- Modernize the IRS through its People, Processes, and Technology.

With the largest enforcement presence in the Service, SB/SE plays an integral role in accomplishing these goals. To that end, SB/SE has developed this plan to focus on the needs of its taxpayers in addition to supporting the accomplishment of IRS and SB/SE

Goals. This plan lays out SB/SE's strategies and priorities and sets forth the organization's direction for the future.

We reviewed the results of the National Research Program (NRP) studies, analyzed organizational performance trends and reviewed the results of external environmental scans. Using the results of these studies and the outcome of various SB/SE senior executive discussions and meetings, we identified the most significant challenges facing SB/SE in the future and developed overall strategies and priorities to guide us in addressing the challenges. Those challenges, strategies and priorities are detailed later in this document in sections III and IV. The following chart shows the linkage of SB/SE's priorities to the IRS Strategic Goals.

LINKAGE OF SB/SE PRIORITIES TO IRS STRATEGIC GOALS

SB/SE Goal / IRS Strategic Goal	Improve Reporting Compliance	Improve Payment Compliance	Improve Filing Compliance	Cross-Cutting/Common to all tax gap areas
Improve Taxpayer Service	Communicate strategic compliance initiatives to internal and external (private, state and federal) stakeholders	Increase and Improve Electronic Payment Strategies	Increase Electronic Interactions	Improve Customer Service
			Develop and Deliver Innovative Strategies to Identify and Meet Stakeholder and Practitioner Needs	Maintain a consistent and coordinated approach to a burden reduction program that meets customer needs
			* Develop Issue Management	
Enhance Enforcement of the Tax Law	Focus on Egregious Non-Compliance and Areas of Highest Strategic Risk Affecting the Tax Gap	Positively Impact Potentially Collectible Inventory	Implement a Comprehensive Multi-Functional Nonfiler Strategy	
	Optimize Examination Program Coverage	Improve Field Collection's Ability to Address Complex Payment Avoidance Tactics		
	Ensure Appropriate Return Preparer Behavior			
	Focus on Identification of Fraud			
	Ensure Appropriate Identification and Development of Issues			
Modernize the IRS Through its People, Processes and Technology	Increase Efficiency and Effectiveness of Operations through Improved Inventory, Workload and Resource Management	Improve Systems, Support Structures, and Productivity to Enhance the Efficiency and Effectiveness of Operations	* Develop Issue Management	Enhance Employee Engagement, Recruitment, Retention, Refreshment and Development
		Leverage Available Technology; Identify and Secure New Technology		Expand Embedded Quality
				Enhance Data Security and Protect Sensitive Information
				Ensure Accomplishment of the SB/SE EEOC 715 Plan

* = This priority fits under both IRS Goals

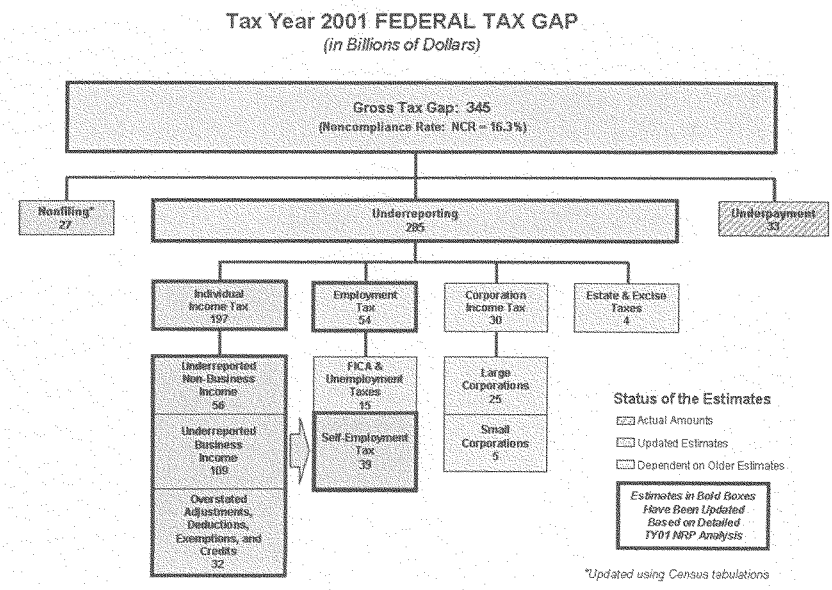
III. WHERE ARE WE GOING? - CHALLENGES FOR THE FUTURE

This plan reflects our efforts to identify, analyze and address the essential and significant issues facing the SB/SE organization and its people in meeting our service and enforcement imperatives. The process both clarified and sharpened SB/SE's focus on the challenges that it must confront in the coming years. The following areas represent the fundamental challenges SB/SE faces in effectively serving our taxpayers. The overall strategies and priorities proposed within this document build a plan to respond to these challenges so that we can fairly and comprehensively meet our taxpayers' needs.

The Tax Gap

The tax gap is the difference between the amount of tax that taxpayers should pay for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual extent of noncompliance with our tax laws. The tax gap is divided into three components: non-filing – failure to file a tax return; underreporting – not reporting one's full tax liability even when the return is filed on time; and underpayment – failure to fully pay reported taxes owed.

The overall gross tax gap for all types of tax is estimated at $345 billion -- for a noncompliance rate of 16.3 percent. Underreporting constitutes nearly 83 percent of the tax gap while nonfiling and underpayment comprise 7.8 percent and 9.6 percent, respectively.

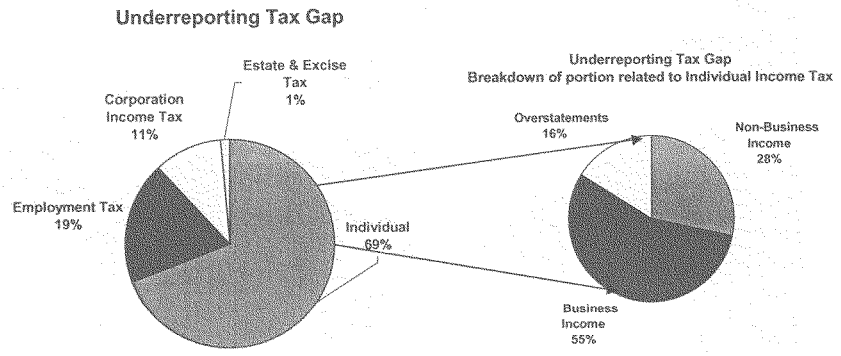


Underreporting Tax Gap

The Underreporting gap, estimated at $285 billion, deals with the accuracy of timely filed returns. Specifically, it addresses the underreporting of income and the overstating of deductions. This portion of the total tax gap is comprised of four major components, Individual income tax, Employment tax, Corporation income tax and Estate & Excise taxes.

Although individual income tax returns account for 46 percent of all tax receipts, individual income tax underreporting is approximately $197 billion or 57 percent of the overall tax gap. The National Research Program (NRP) findings demonstrate that well over half ($109 billion) of that individual underreporting gap is the result of understated net business income (unreported receipts and overstated expenses). By itself, this accounts for over 31 percent of the total tax gap.

Approximately 28 percent ($56 billion) of the individual underreporting gap came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated reductions of income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits.



Employment tax is the second largest contributor to the underreporting tax gap accounting for $54 billion. Approximately 72 percent ($39 billion) of that amount comes from self-employment tax. Self-employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and employment tax together, we see that individual underreporting constitutes over 70 percent of the gross tax gap.

The NRP study also tells us that compliance rates are higher on tax returns that 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 (NMP) for wages and salaries is only 1 percent. This has not changed dramatically since the last compliance study in 1988.

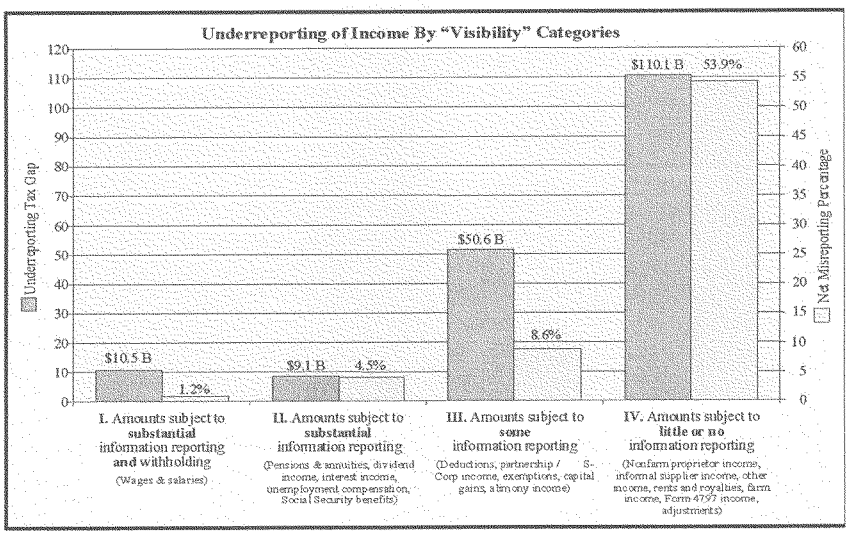
By contrast, amounts subject to third-party information reporting, but not to withholding (interest and dividend income), exhibit a somewhat higher misreporting percentage. For example, there is about a 4 percent misreporting rate for interest and dividends.

Finally, amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher misreporting percentage (e.g., 12 percent for capital gains). As expected, amounts 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 misreporting estimate for "other income" results in $23 billion of tax. The following charts depict misreporting estimates for all visibility categories.

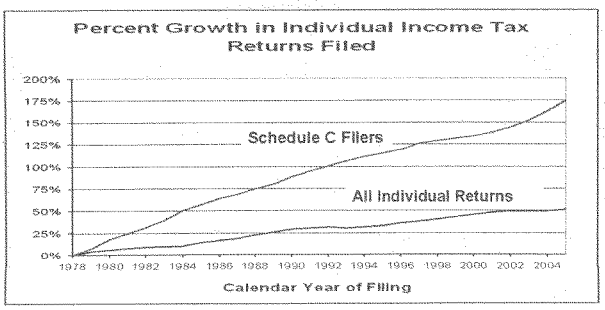
Individual Income Tax Underreporting Gap Estimates for Tax Year 2001 Grouped by Visibility Category

Category	Tax Gap ($ Billions)	Net Misreporting Percentage
Items Subject to Substantial Information Reporting and Withholding	**10.5**	**1.2%**
Wage Income	10.5	1.2%
Items Subject to Substantial Information Reporting	**9.1**	**4.5%**
Interest Income	1.6	3.6%
Dividends	1.1	3.7%
Pensions & Annuities	4.2	4.1%
Unemployment Compensation	0.5	11.1%
Social Security Benefits	1.1	5.8%
State Tax Refunds	0.6	11.6%
Items Subject to Some Information Reporting	**50.6**	**8.6%**
Partnership/SBC/E&G/etc.	22	17.8%
Alimony Income	*	7.2%
Capital gains	11	11.8%
Deductions	13.5	5.4%
Exemptions	4.2	5.4%
Items subject to Little or No Information Reporting	**110.1**	**53.9%**
Form 4797 Income	3.3	64.4%
Other Income	22.6	63.5%
Nonfarm Proprietor Income	68	57.1%
Farm Income	5.8	72.0%
Rents & Royalties	13.4	51.3%
Total Adjustments	-3	-21.1%
Not Shown on Visibility Chart	**17.1**	**26.3%**
Credits	17.1	26.3%
Total	**197.4**	**18.0%**

Income amounts in the least visible group, amounts subject to little or no information reporting, had a 53.9% net misreporting percentage and accounted for $110.1 billion of the tax gap for TY2001. SB/SE will be further challenged as more taxpayers receive income in this category.



Adding to SB/SE's challenge is the dramatic growth in Schedule C filers, with the number of new Schedule C filers increasing by 6.8 percent from 2000 to 2002. The Predicted Tax Change for these filers increased by 10.5 percent for the same period. In FY 2005, SB/SE examined over 279,000 tax returns with Schedule C's. In 56 percent of these audits, Gross Receipts were adjusted with an average adjustment of $69,270; Other Expenses were adjusted 74 percent of the time with an average adjustment of $4,395; and, Car and Truck Expenses were adjusted 72 percent of the time with an average adjustment of $4,374.



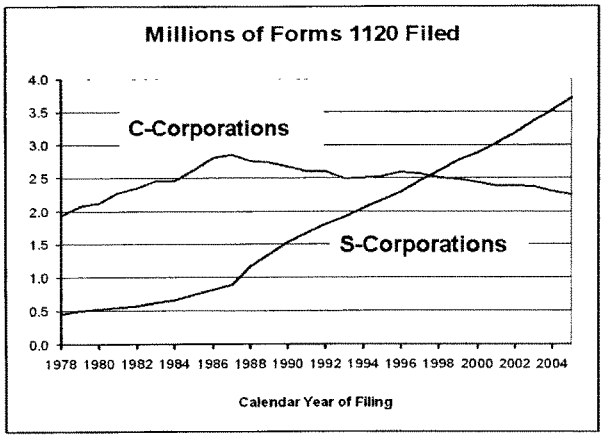
The next NRP study already being launched will focus on S Corporations and will form part of a portfolio of rolling annual reporting compliance studies. Each study will address a component of the overall tax gap. By measuring compliance for various types of taxes and taxpayers, we will be better able to target resources to encourage compliance, deter non-compliance and reduce the burden on taxpayers.

Over the last twenty years, S corporation return filings have increased dramatically. In 1985 there were 722,444 Form 1120 S returns filed by companies with less than $10 million in assets. By 2002 that number had quadrupled to over 3.1 million. By contrast, 450,000 fewer non-1120S corporate returns were filed over the same period.

By 1997, S corporations had become the most common corporate entity. In 2003, nearly 3.4 million S corporations filed tax returns, accounting for over 58 percent of all corporate returns filed that year. The last time we conducted an S corporation study was 1984. As a result, we do not have reliable reporting compliance data for these entities.

In FY 2004, the IRS examined 6,402 S corporation returns, or less than one-fifth of one percent of all S corporation returns filed. That coverage rate is one of the lowest for any type of tax return examined by the IRS. In comparison, the IRS examined 17,097 1120C corporations and 6,226 partnership returns in FY 2004, producing coverage rates of 0.71 percent and 0.26 percent, respectively.

The current NRP study of reporting compliance involves approximately 5,000 Form 1120S returns from a nationwide random sample. We used asset size of the S corporation in the return selection process. Even with the increased focus from the NRP study, the overall audit rate for S corporation returns remains below that for C corporations.



SB/SE also faces risk to its efforts to close the Reporting Tax Gap from abusive tax schemes, reporting of flow-through income, and high-income individuals. In many ways, these three areas converge with flow-through entities becoming a prime channel for tax avoidance by the wealthy. Abusive "Offshore" tax schemes involve the use of foreign jurisdictions that have enacted financial secrecy laws in an effort to attract investments from outside their borders. Domestic promotions lure taxpayers with the promise of tax benefits that are false and not in conformity with current law and are being marketed as devices that reduce, eliminate, or help evade income, self-employment, employment, estate, gift, and/or excise taxes. Internet based businesses present a high risk primarily because they are portable and site registration procedures allow them to mask their identity.

Trust, Partnership, and S-corporation returns are referred to as flow-through returns because they pass their income through to beneficiaries, partners, and shareholders. These returns can present exponential risks to the tax base since failing to file, filing late, or underreporting income on the flow-through return adversely impact the returns on which the income is to be reported. About 9.2 million flow-through returns were filed in 2002 passing more than one trillion dollars to their beneficiaries, partners, and shareholders. Many high-income taxpayers invest in flow-through entities and/or engage in offshore financial transactions to defer or hide potential taxable income. Domestic promoters market both legitimate trusts and abusive tax schemes to high-income taxpayers to reduce or eliminate income taxes.

Nonfiling Tax Gap

The Nonfiling Gap, estimated at $27 billion, is the tax that is owed but not paid voluntarily and timely by those who fail to file required returns by their due date. By this definition, the nonfiling gap is the net of any tax paid by or on behalf of these taxpayers before the due date of the return (e.g. through withholding), and that this includes the gap generated by those who file late.

For Tax Year (TY) 2002, 74.3 percent of Business Master File (BMF) modules were timely filed, 16.3 percent were filed late, and 9.4 percent were not filed at all. Data for TY 2002 indicates that 96.2 percent of SB/SE Individual Master File (IMF) returns were timely filed and 3.8 percent were filed late. Form 941 Employment Tax modules represent the largest portion of the BMF nonfiler modules (31.6 percent), as well as the largest segment of the BMF delinquent filers (35.9 percent). Corporate filers (Forms 1120 and 1120S) account for 29.6 percent of the BMF nonfiler modules.

While SB/SE IMF nonfilers accounted for 30.6 percent of the servicewide IMF nonfiler modules with a net tax due in 2002, they made up 55.4 percent of the nonfilers with net tax due greater than $1,500. Overall, SB/SE nonfilers with a net tax due increased by 1.5 percent from 2000 to 2002. This is less than the servicewide increase of 9.7 percent.

In 2002 SB/SE IMF nonfilers accounted for 65.6 percent of the servicewide IMF high income nonfilers (greater than or equal to $100 thousand). From 2000 to 2002 the number of SB/SE IMF high income nonfilers increased by 19.5 percent. Servicewide the increase was 6.7 percent.

In 2002, 1.4 million SB/SE IMF returns were filed late. Of the 1.4 million delinquent filers, 388 thousand filers were in a balance due status and represented $1.7 billion. The 1.4 million SB/SE IMF late returns represent an increase of 18.7 percent from 2001. In addition, late balance due returns increased by 11.6 percent from 2001 to 2002.

Among delinquent SB/SE IMF filers in balance due status, the dollars owed are dominated by Schedule C filers (61.6 percent). The number of SB/SE IMF delinquent Schedule C filers with a balance due increased by 7.7 percent from 2001 to 2002. The dollars owed by these filers increased 3.1 percent for the same period.

SB/SE IMF taxpayers with an Adjusted Gross Income > $100 thousand account for 14.7 percent of delinquent filers with a balance due and owe $920 million. This is 54.0 percent of the total dollars owed from SB/SE IMF delinquent filers in balance due status. From 2001 to 2002, the number of these SB/SE IMF delinquent filers in balance due status increased by 8.0 percent and the dollars owed increased by 2.1 percent.

Underpayment Tax Gap

The underpayment tax gap, estimated at $33 billion, is the amount of tax that is reported on timely-filed returns, but is not paid voluntarily and timely. The NRP monitors the underpayment gap by tabulating unpaid self-assessments on timely-filed returns for all types of tax for all populations of taxpayers. In the latest NRP measure of the gap, the annual underpayment gap is $33 billion. Unlike the other two types of noncompliance, underpayments can be observed in their entirety, and do not need to be estimated.

As of September 30, 2005, SB/SE accounted for 57.0 percent (14.3 million) of the cumulative Unpaid Assessments modules nationwide and 68.2 percent ($175.9 billion) of the related dollars. Potentially Collectible Inventory (PCI) is a subset of the IRS' Unpaid Assessments. It paints a high-level picture of active accounts. PCI is growing, and SB/SE is responsible for the largest portion. Total PCI increased from $65.3 billion in September 2001 to $86.3 billion in 2005, with SB/SE IMF showing the most growth. Over the last four years, the BMF portion of PCI increased 13.8 percent, Wage & Investment (W&I) IMF increased 7.9 percent, and SB/SE IMF increased 76.0 percent. SB/SE's PCI can be categorized by major source of assessment, of which "Balance Due" returns is typically the largest. However, much of SB/SE's PCI originates from enforcement activity, as illustrated in the tables below:

SB/SE BMF PCI by Major Source of Assessment

Source of Assessment	Total ($ Billion)	Share of Total
Balance Due	$6.8	37%
TDI	$3.2	17%
Adjustment	$1.9	10%
Exam Assessment	$1.9	10%
Penalty	$1.8	10%
Credit Discrepancy	$1.4	8%
6020B/ETE/ETAP	$1.0	5%
All Other Sources	$0.6	3%
Total	$18.6	100%

Source: BPMS Extract for September 2005

SB/SE IMF PCI by Major Source of Assessment

Source of Assessment	Total($ Billion)	Share of Total
SFR/ETE	$12.9	34%
Balance Due	$11.2	29%
Exam Assessment	$4.6	2%
100% Penalty	$3.9	10%
TDI	$3.2	8%
Underreporter	$1.1	3%
Delinquency	$0.5	1%
Adjustments	$0.4	1%
All Other Sources	$0.5	2%
Total	$38.3	100%

Source: BPMS Extract for September 2005

Substitute for Return (SFR) and similar cases are driving increases in PCI. Between September 2001 and September 2005, PCI from BMF SFR-type cases grew from $714 million to $1.0 billion (52.0 percent). From IMF W&I cases, it grew from $7.1 billion to $9.1 billion (29.0 percent). From IMF SB/SE cases, it grew from $2.1 billion to $12.9 billion (626.6 percent). Overall, PCI from these cases increased from $9.8 billion to $23.1 billion (234.9 percent). Although SFR-type assessments increase PCI, they also create assessments on which the IRS can pursue collections and result in several billion dollars in revenue each year that otherwise would not be collected.

Customer Satisfaction Data

Customer service is a core component of SB/SE activities. Since stand-up in October 2000 when SB/SE assumed several existing transactional customer satisfaction surveys and launched new ones, SB/SE senior management has been attempting to better

understand and meet the needs of our customers. In FY 2004, SB/SE also began conducting customer base and practitioner surveys. These surveys allow SB/SE to hear from all segments of its customer and practitioner base on a broad range of customer and practitioner service experiences and issues. Results of both the transactional as well as the customer/practitioner base surveys indicate that customers are generally satisfied with SB/SE's performance, products, and services.

However, SB/SE must still pursue actions to address the most problematic aspects of the customers' experience. From the surveys over the past few years, the same few key themes continue to persist as "sore points" for transactional survey customers:

"Voice of Customer"	Translation
"You take too long/too much of my time"	Our processes take too long from the customer's perspective.
"I don't understand what you're telling me and you don't tell me it when I need to know."	Our oral and especially written/printed communications are gummed up with "legalese." We are leaving customers in the dark about case developments and progress that are important to them.
"You are not treating me fairly."	Among other things, penalties and interest. Customers learn they have run afoul of us too late after the fact and the "meter keeps running" while we conduct our lengthy processes.
"If you'd resolve my issue, I would be more satisfied."	Case resolution significantly impacts the customer's satisfaction in ACS.

Survey reports focus on aspects of the customer's experience that are not controllable – and thus not significantly improvable – by front-line managers. They reflect policies, business practices, resources, service delivery tools and systems that are within the purview of HQ program managers.

SB/SE has made substantial progress in a number of areas in its effort to improve the experience of customers. As measured by the Customer Base and Tax Professionals surveys, which are not exclusively focused on post-filing enforcement dealings, the following progress is evidenced:

	CUSTOMER BASE			TAX PROFESSIONAL		
Response	2003 Percent	2004 Percent	2005 Percent	2003 Percent	2004 Percent	2005 Percent
Satisfied (4-5)	48%	60%	61%	55%	61%	59%
Neutral (3)	37%	29%	26%	41%	31%	34%
Dissatisfied (1-2)	16%	11%	13%	4%	8%	8%
Average Overall Satisfaction Mean	3.46	3.77	3.75	3.55	3.64	3.59

Statistically Significant | Not Statistically Significant | Statistically Significant | Not Statistically Significant

One area of improved service is the expansion of e-filing. A comparison of SB/SE e-file volumes from FY 2004, FY2005, and through March 2006 FYTD shows that BMF e-file volumes are growing. The Electronic Tax Administration (ETA) Dashboard which is a central repository of data for all of electronic submissions is used to track the volumes. The ETA Dashboard reflects actual returns posted, and therefore, may differ from other data sources.

SB/SE e-File Volumes

SB/SE BMF Form Type	March 2006 FYTD	FY2005	FY2004
1040 Schedule C	4,280,606	8,989,860	7,519,041
1040 Schedule E	2,092,627	5,952,678	4,856,424
1040 Schedule F	437,520	841,752	733,470
1040 SB Form 2106	2,264,288	3,802,091	3,484,628
Form 940	1,022,374	951,884	412,329
Form 941	2,237,779	5,046,511	4,228,808
Form 990	2,835	3,236	465
Form 1041	454,478	1,350,186	1,328,445
Form 1120	245,023	200,923	47,530
Form 1065	108,352	170,571	91,159
BMF Subtotal	**4,070,841**	**7,723,311**	**6,108,736**

Internet EIN is experiencing an 18 percent growth with current volume at 1,294,695.

The growth in BMF e-file is patterning close to the overall growth that the IRS is seeing in 1040 e-file. The 940, 1041, and 1120/S returns are leading the growth for BMF:

- 940 is experiencing growth of 101.39 percent over previous year
- 1041 is experiencing growth of 97.27 percent over previous year
- 1120/S is experiencing growth of 123.85 percent over previous year

The rise in BMF e-file is attributable to a number of key factors, such as:

- Corporate mandate spillover
- Implementation of the modernized efile platform (1120/1120S) has created a rise in all other business efile programs (1065, 940, 941)
- Reduction in threshold for e-services to the practitioner community
- Outreach/education/marketing of liaison team (both national and local)
- Enhanced web presence coupled with the rise in web hits/visits
- Effect from increase in state mandates

In improving its service performance, SB/SE challenges include:

- Improving customer service in an enforcement organization where customer satisfaction measurements (percent satisfied or percent dissatisfied) are not 'pure' summations of the customer's experience because other case-related factors, such as case outcome, are key determinants of the score
- Improving the use of the transactional surveys to concentrate on the post-filing aspect of the customer experience and focus on those who have had an interaction with the IRS
- Enhancing our ability to leverage customer feedback by getting behind the numbers and hear the voice of the customer about his or her experiences of dealing with us
- Enhancing SB/SE capacity to translate customer results into customer- and business-oriented improvements
- Sustaining the use of the customer/practitioner base surveys to all SB/SE customer segments on a broad range of customer issues to help SB/SE Senior Leadership better develop new strategies for improving taxpayers' effectiveness in dealing with the IRS
- Creating awareness of the new IRS brand "electronic-IRS" as the umbrella brand for all e-interactions
- Conducting outreach and marketing to increase e-filing. With fifty percent of the audience reached, the focus has been directed to persuading a more resistant audience to file and pay electronically.
- Incorporating facets of electronic interaction into all components of SB/SE's strategy (filing compliance, reporting compliance, payment compliance and reducing burden).

Employee Engagement

The IRS defines employee engagement as the degree of employees' motivation, commitment and involvement in the mission of the organization. Historically, the IRS had relied solely on the annual employee survey to measure employee engagement. Results were compiled for workgroups. Action plans were prepared by each individual work group to address the workgroup issues. However, employee engagement encompasses more than just the employee satisfaction survey.

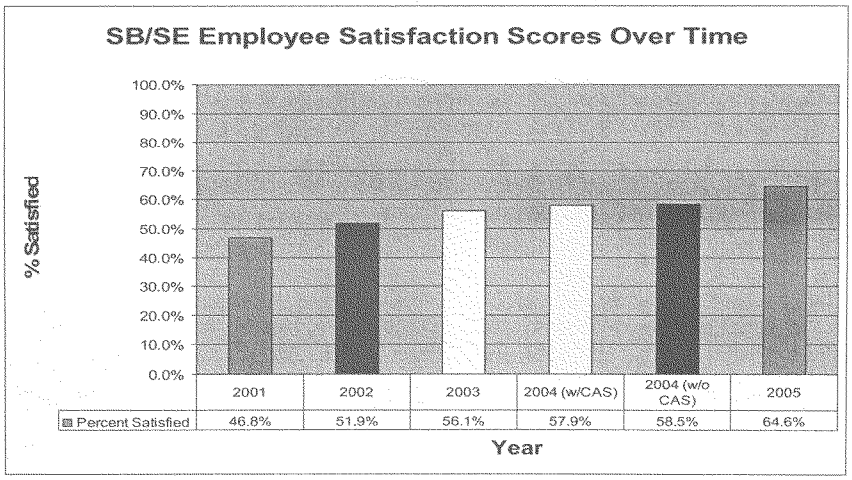
The annual survey results are still a very good indicator of whether employee engagement is improving since the two are closely associated. The annual employee satisfaction survey has been conducted by the Gallup Organization since 2001. Gallup "Q12" questions were designed to measure Employee Engagement. All of the dimensions of work life addressed in the Gallup Q12 are relevant to satisfaction outcomes.

Gallup defines an engaged employee as: "*...one who is 100% psychologically committed to their role. They thrill to the challenge of their work every day. They are in a role that uses their talents, they know the scope of their job and they are always looking for new and different ways of achieving the outcomes of their role.*"

The IRS developed additional questions to supplement the "Q12" questions. IRS' official measure of Employee Satisfaction is based on an "Overall Satisfaction" question. Employee Satisfaction results are derived from the percentage of all respondents that rate this question as either a "4" or a "5" on a 5-point scale.

Survey question 17 asks: *"Considering everything, how satisfied are you with your job?"*

The following chart shows that SB/SE's scores on the overall satisfaction question have steadily improved from Survey 2001 through Survey 2005. The overall satisfaction score has increased by 17.8 percentage points from 2001 (46.8 percent) to 2005 (64.6 percent). Representing a 38 percent increase.



Employee engagement encompasses more than just the results generated by the survey process. Employee engagement is part of daily interactions of workgroups and discussions of employee engagement should be conducted as part of regular on-going group meetings. Integrating employee engagement activities into daily operations is an important step towards having a more engaged and efficient workforce.

Data Security

Recent news stories regarding the loss of laptop computers containing sensitive data serve to remind us how important it is to safeguard taxpayer, employee and other personally identifiable information and to ensure the security of media containing other sensitive but unclassified (SBU) data. According to the FBI, identity theft is one of the fastest growing white collar crimes. There has been a 4,600 percent increase in computer crime since 1997. Nearly 20 million Americans lost their identities over the past two years, according to the Federal Trade Commission. Deloitte-Touche recently reported that financial institutions and U.S. banks have also experienced a significant increase in the number of computer based attacks and attempted intrusions into financial systems.

Every year, the IRS processes approximately $2 trillion in revenues to fund the U.S. operating budget. Although the majority of this is collected in an automated banking system throughout the year, about $300 billion is collected through eight IRS campuses where taxpayers send their tax returns for processing. The IRS houses computing systems that hold data on all taxpayers and also process enormous volumes of paper data in our more than 500 offices across the country. The IRS has more than 82,000 full time and 12,000 part-time employees across the U.S.

Taxpayer and employee privacy is a foremost concern of the IRS. We are charged with protecting the most critical information about virtually every American. In recognition of this responsibility, we continue to update our systems and our training so that employees who have access to sensitive information are aware of the steps they must take to prevent that information from being compromised.

IRS has very stringent data security policies and guidelines requiring the use of encryption technology for all taxpayer, sensitive and private information on all IRS equipment, especially easily portable equipment such as laptops and storage devices. In light of recent security incidents, increased vigilance is required in ensuring existing policies and procedures are enforced and enhanced where necessary.

What's it all mean?

SB/SE bears a unique responsibility for the major components of the Tax Gap. In each of its major components – Reporting, Payment, and Filing, the largest and most problematic subcomponents are SB/SE taxpayers. SB/SE must have two overall objectives that guide efforts to make headway against the Tax Gap:

- Changing the underlying taxpayer reporting, paying, and filing behaviors – which can stem future growth
- Actually getting the dollars associated with the Tax Gap into the Treasury – which is "closing" the Tax Gap.

Achieving these objectives requires effective and sustained actions along four broad avenues of approach:

- Increased and more productive enforcement activity
- A better fit and a more agile deployment of resources arrayed against the key Tax Gap subcomponents
- Improved service to taxpayers to facilitate their understanding and fulfillment of their tax responsibilities
- Legislative proposals that address both enhancing enforcement tools and easing taxpayer's compliance burden.

The first two avenues challenge SB/SE's leadership to make sure one-on-one enforcement is adequately resourced, correctly targeted across functions, and supported with enhanced tools – workload selection, case development, case processing – that increase front-line performance. The latter two avenues challenge SB/SE's leadership to recognize that audits, liens, and levies – in general, one-on-one enforcement – are limited when compared to the magnitude of the Tax Gap and in their efficacy to affect large-scale changes in taxpayer behavior.

Although there are distinct challenges and opportunities associated with each of the Tax Gap subcomponents for which SB/SE is responsible, the overall path ahead has both critical obstacles and significant opportunities:

- The loss of seasoned front-line enforcement employees through pending retirements and accelerating attrition is a "make-or-break" issue as SB/SE seeks to make headway against the Tax Gap. The potential loss of knowledge bases is even more challenging than the numbers of employees lost

- Significant Tier B investments offer the promise of marked gains in productivity and in capturing expertise systemically.

IV. HOW DO WE GET THERE? - MEETING THE CHALLENGES - STRATEGIES AND SPECIFIC PRIORITIES

The latest research data indicates that the principal areas of risk are filing, paying and reporting compliance. Failure to detect and respond to filing, payment and reporting noncompliance reduces tax revenue and undermines the voluntary compliance system, hindering SB/SE's ability to enforce the nation's tax laws. SB/SE must continuously impact and improve the voluntary compliance of SB/SE taxpayers using an appropriate balance of enforcement and non-enforcement techniques. SB/SE must help taxpayers understand their tax obligations and make it easier for them to participate in the tax system. The organization must meet the challenges posed by abusive tax avoidance transactions, flow-through income and high-income individual taxpayers.

To effectively address these challenges, SB/SE has established the following strategies:

- Improve Reporting Compliance
- Improve Payment Compliance
- Improve Filing Compliance

To further refine our strategies we developed specific priorities that strengthen our focus on increasing voluntary compliance. We have targeted specific, externally focused actions that must be accomplished to improve voluntary compliance while refining internal processes and technological capabilities. Some of our priorities are addressed not to one or other of the Tax Gap areas but rather represent courses of action that are fundamental to or supportive of improvements in all three components of the Tax Gap.

SB/SE has also developed an overall Technology Concept of Operations that identifies the common technology needs for the future. A Compliance Concept of Operations has also been developed to outline the necessary capabilities to operate successfully and to link those capabilities to technology and business initiatives. In addition, each operating unit within SB/SE develops annual Program Letters to focus its activities and guide the direction of the organization.

A matrix of SB/SE's priorities and related planned actions is included as Addendum I.

STRATEGY: IMPROVE REPORTING COMPLIANCE

SB/SE must maintain a strategic approach to address chronic non-compliance while protecting the tax base. A balanced approach must be taken to address willful violations while ensuring that the current compliance rate does not erode. This includes providing timely, accurate and aggressive risk identification and delivery of workload. The following priorities and Technology Investments will focus SB/SE efforts to successfully reduce the Tax Gap and mitigate risks.

Improve Reporting Compliance	
Priority	Technology Investment
Focus on Egregious Non-Compliance and Areas of Highest Strategic Risk Affecting the Tax Gap	Compliance Data Environment (CDE & RBE)
Optimize Examination Program Coverage	Risk Based Scoring System (RBSS)
Ensure Appropriate Return Preparer Behavior	Servicewide Employment Tax Research System (SWETRS)
Focus on Identification of Fraud	Examination Desktop Support System (EDSS)
Ensure Appropriate Identification and Development of Issues	Correspondence Examination Automation Support (CEASrev1)
Increase Efficiency and Effectiveness of Operations through Improved Inventory, Workload and Resource Management	Automated Underreporter (AUR)
Communicate strategic compliance initiatives to internal and external (private, state and federal) stakeholders	

Priorities

Focus on Egregious Non-Compliance and Areas of Highest Strategic Risk Affecting the Tax Gap: The Examination program will focus enforcement resources on areas of egregious non-compliance by considering areas of strategic risk such as:

- Abusive scheme promoters and participants
- Return preparers
- High-income taxpayers
- Third party payers including Professional Employer Organizations and Payroll Service Providers
- Non-filer audit referrals.

Area offices will be encouraged to identify egregious activities through Compliance Initiative Projects (CIP) and Return Preparer Program cases appropriate for Field Examination. Increased emphasis will be given to returns with Schedule C activity that correlates to the tax gaps. The NRP study of Sub-Chapter S Corporation cases (1120-S NRP cycle) will be a key factor to measuring Compliance. NRP cases will be developed to the appropriate depth for the issues identified. Likewise, the associated multi-year and related return examinations will be initiated and completed timely.

In the Specialty Programs area, employment tax cases will focus on leveraging nationally identified noncompliance in the areas of Currency Banking Retrieval System leads, 941

non-filers, and Corporate Officer non-reporting. Estate and Gift will continue to address non-compliance associated with Family Limited Partnerships.

Campus Compliance Services (CCS) will monitor productivity of high-risk inventories and Total Positive Income (TPI) codes will be profiled for potential sources of noncompliance. Mechanisms will also be established to link TPI class/prior year performance to inventory selections.

Optimize Examination Program Coverage: Examination will implement a corporate strategy to ensure optimum audit coverage and results and provide a balanced approach for return delivery and allocation of staffing. Balanced coverage will be provided in the following categories:

- Individual returns <$100,000
- Individual returns >$100,000 but <$200,000
- Individual returns >$ 200,000
- Small Business Corporations
- Small Business Flow-Through Entities for S Corporations, Fiduciaries, & Partnerships

We will develop and implement an Employment Tax Strategy to improve employment tax compliance. The strategy will increase compliance and reduce burden of employers in the filing, reporting and payment of employment taxes.

CCS will coordinate with Wage and Investment to:

- implement a corporate strategy to maximize audit coverage and results
- streamline work plan process to ensure consistent resource and inventory allocations among the campuses
- ensure successful transition to Corporate Inventory concept
- develop measures to determine efficiency and effectiveness of partnering efforts.

In addition, CCS ensures that mandatory compliance reviews are completed, referrals are examined, and high risk entities are identified and examined.

Fraud/BSA will identify and conduct examinations in high risk geographic locations that have had no prior or only minimal coverage. They will effectively address BSA compliance consistent with recent legislation for the insurance industry and dealers in precious metals, gems and jewels.

Ensure Appropriate Return Preparer Behavior: We will identify and address practitioners and return preparers who encourage taxpayers to take overly aggressive positions on their tax returns and/or do not fully cooperate to resolve examinations issues timely. We will improve education and outreach activities to ensure practitioners recognize inappropriate behavior and are aware of the associated penalties. We will also ensure that referrals and/or penalties are asserted when appropriate. Preparer penalties

will be developed and practitioners will be referred to the Office of Professional Responsibility when appropriate. Practitioner behavior will be used as an indicator in the workload identification process.

Focus on Identification of Fraud: In all our examination activities, we will focus on increasing awareness of indices of fraud. We will identify the most noncompliant taxpayers through targeted workload and a "taking the right action at the right time" approach. Better equipping our workforce to recognize, identify and develop badges of fraud will result in improving the quality of fraud referrals. We will also identify as areas of focus those industries, issues and/or taxpayers who attempt to evade their responsibilities.

The Fraud area will:

- Provide technical and procedural guidance in the identification and development of potential criminal fraud referrals and civil fraud penalty cases
- Support the Service-wide development of criminal fraud referrals and civil fraud penalties
- Assist in the identification and development of potential fraud leads as well as the recommendations for injunctions and referrals to the Office of Professional Responsibility
- Establish leveraged partnerships with Criminal Investigation (CI), all IRS Operating Divisions and Functions to increase fraud awareness and support the fraud program objectives.

Ensure Appropriate Identification and Development of Issues: We will provide the tools necessary to further develop employees' abilities to ensure appropriate identification and development of issues. We will develop issue specific procedures and training modules and provide the analytical tools and services needed to support manual and automated establishment and adjustment of issue detection criteria and thresholds.

Completion of the NRP study has enabled the IRS to retool its workload identification process for the first time in over 20 years. Two major enhancements in workload delivery are the new workload identification formulas and restructuring examination classes. SB/SE will use the new examination classes and the new workload identification formulas to refocus our enforcement efforts to areas contributing the most to the tax gap while minimizing the disruption on compliant taxpayers.

We will continue to identify and develop more effective methods for deterring Abusive Tax Avoidance Transactions (ATAT) activity. We will use civil injunctions to shut down the promotion of schemes. We will ensure that high-profile convictions, sanctions, and injunctions are well publicized and ensure that enforcement measures are targeted at promoters of schemes. We will continue to use Lead Development Centers (LDC) to research, evaluate and assign promoter leads and referrals to the field.

We will conduct an ongoing risk assessment of emerging BSA compliance issues and use the information to plan and direct our BSA compliance strategies. Additional issues will be identified through improved data collection, exchange of internal data, and the analysis of the data from management information systems.

The CLD area will use the Issue Management and Resolution System (IMRS) to track, resolve and analyze concerns to identify compliance trends. In addition, they will secure and analyze issues raised by national and local practitioner and stakeholder liaison activities to identify significant issues and concerns to reduce barriers to voluntary compliance, relieve taxpayer burden, and ensure that appropriate policies and procedures are in place.

Increase Efficiency and Effectiveness of Operations through Improved Inventory, Workload and Resource Management: We will monitor and analyze inventory needs, inventory available and inventory in process to ensure inventory is available when needed and delivered timely to support workplan needs. We will take steps to reduce overage and cycle time and to minimize hours per return and multiple-year and related return examinations. Revenue Agent (RA) examinations will be conducted at the taxpayers' premises whenever possible to increase productivity. Risk analysis tools, like 80/20, will be utilized and manager will be involved throughout the entire examination process to ensure our goals are achieved. Analytical tools and services that allow SB/SE managers to predict and adjust workload volume, develop operational plans, make resource decisions, and set workload priorities will be provided.

The BSA area will identify entities that are at the highest risk for BSA noncompliance using an enhanced workload identification system. We will increase access to researchable electronic data to improve case building capabilities. Our management information systems will be enhanced to improve the accuracy, reliability, and accessibility of data.

Communicate strategic compliance initiatives to internal and external (private, state and federal) stakeholders: The CLD area will ensure that information is consistently communicated to practitioners and stakeholders. CLD will work with tax professionals and other partners that are most critical to influencing reporting compliance to develop and deliver appropriate messages through leveraged communications opportunities. Key policy and procedural messages related to strategic compliance initiatives will be consistently delivered to practitioners at the local level, including information related to non-bank financial transactions.

CLD will also work with the state taxing authorities to:

- Maintain and improve existing partnership relations
- Identify productive uses of leads
- Ensure the states have the opportunity for training, as appropriate
- Share Revenue Agent Reports (RARs) early in the process.

We will also work with Large and Mid-Sized Business (LMSB) to develop processes for sharing information, pursuing emerging issues on tax shelters, and identifying joint training opportunities.

Technology Investments

Compliance Data Environment (CDE & RBE): We will build a comprehensive data asset including data from both internal and external sources to replace an aging, limited capacity system used to identify and select cases for examination in SB/SE. The new data store will be used as a research tool to help identify patterns of non-compliance and characteristics of non-compliant returns, as well as an operational platform that will identify, select and build higher quality cases for examination. CDE will also serve as an important data asset for use by other operating divisions in IRS.

Risk Based Scoring System (RBSS): Utilizing the expanded availability from the CDE data platform, RBSS will build algorithms to identify and select cases for audit through the campus correspondence examination program. This new capability will improve the Service's ability to select the cases with the highest compliance potential and avoid working cases that will result in no change.

Servicewide Employment Tax Research System (SWETRS): Building from the CDE platform, SWETRS will utilize data from a number of internal and external sources to perform research and build algorithms to identify and select employment tax returns and issues for examination. Employment tax non-compliance is a significant portion of the tax gap, and SWETRS will be the primary tool used to ensure that IRS is identifying patterns of non-compliance and selecting the most effective cases for examination.

Examination Desktop Support System (EDSS): This project will replace the current Report Generation System (RGS) used by revenue agents and tax compliance officers in SB/SE to make tax computations generate correspondence and reports to taxpayers, complete examination work papers, etc. The new system will provide a tax computation for individual taxpayers that will be a shared service utilized by other systems and operating divisions. EDSS will enhance the productivity of examiners and will integrate with the CDE to expand the information that is automatically provided to the examiner at the beginning of an audit.

Correspondence Examination Automation Support (CEASrev1): This project will replace the current RGS/RGS Batch systems and become the primary tool used in the campuses for correspondence examinations. CEAS will improve the efficiency of the program by automating redundant case management tasks, eliminating unnecessary manual tasks, improving the accuracy of examinations and allowing more flexibility in managing cases in the campus examination environment.

STRATEGY: IMPROVE PAYMENT COMPLIANCE

Achieving the goal of Increasing Payment Compliance is dependent upon maintaining focus on basic priorities while remaining versatile enough to add or adjust actions as needed in response to critical issues that arise. Based on the amount of potential liability and the degree of risk associated with its recovery, enforcement activities may cycle successively through notices to phone or in-person contacts with the application of appropriate enforcement tools for each particular situation. SB/SE must work aggressively to improve payment compliance by timely applying complex enforcement tools and improving the efficiency and effectiveness of operations. The following priorities and Technology Investments will focus SB/SE efforts to successfully guide Collection activities.

Improve Payment Compliance	
Priority	Technology Investment
Positively Impact Potentially Collectible Inventory	Electronic Installment Agreements (e-IA)
Improve Field Collection's Ability to Address Complex Payment Avoidance Tactics	Universal Case History (employee access to complete taxpayer history
Increase and Improve Electronic Payment Strategies	Expand Compliance Date Warehouse (CDW)
Improve Systems, Support Structures, and Productivity to Enhance the Efficiency and Effectiveness of Operations	Pre-Populated Collection Information Statement (PCIS)
Leverage Available Technology; Identify and Secure New Technology	Consolidated Decision Analytics – Inventory Delivery System (IDS) Enhancement
	Electronic Filing of Federal Tax Liens (e-Lien)

Priorities

Positively Impact Potentially Collectible Inventory: As the tax gap grows, it becomes increasingly important to work aggressively to reduce the underpayment portion. We will improve the currency of Field Collection inventory (reduce overage and potentially overage accounts) by:

- Improving workload management practices
- Working cases strategically by taking simultaneous actions where possible
- Improving response time on Taxpayer Advocate Service issues

We will also take steps to:

- Minimize pyramiding of taxpayer accounts
- Improve monitoring of taxpayer compliance
- Strengthen the Federal Payment Levy Program
- Leverage the unique skills of Field Collection to increase field time thereby closing more cases, collecting more dollars and improving overall compliance

- Increase the timely pursuit and appropriate application of complex enforcement tools such as seizures, nominee liens, transferee assessments and suits to protect the government's interest in liabilities owed
- Improve the Insolvency program's use and timeliness of administrative and judicial remedies to promote compliance of bankrupt taxpayers.

In order to accomplish these steps we will employ a number of innovative strategies to guarantee coordination with the other collection operations and achieve optimal results. We will lead the newly formed Collection Governance Council to better manage collection inventories from an enterprise perspective, thereby providing a more comprehensive strategy and broader integration between BODs and programs. This will cover both balance due delinquencies as well as un-filed returns. We will initiate research to explore better ways to select cases with the best collection potential and determine the appropriate treatment. We will advance our use of decision analytics by testing new filters for 941 delinquencies which will result in better predictions of collection potential using data from a variety of new sources. We will continue to leverage our newly developed enterprise wide Non- Filer Workplan to focus management attention on the resources committed and accomplishments in addressing this portion of the tax gap.

Improve Field Collection's Ability to Address Complex Payment Avoidance Tactics: We will enhance Field Collection's ability to handle complex casework and provide the ability to incorporate new compliance initiatives into inventory as emerging issues arise. We will incorporate emerging Examination compliance initiatives into Field Collection planning and workload delivery processes and collaborate, as appropriate, with other stakeholders such as Counsel, Appeals and the TAS. We will determine impact of e-commerce non-compliance on the Field Collection workload. In addition, we will enhance our ability to develop high quality fraud referrals by improving fraud recognition and coordination with Exam, BSA and CI.

Increase and Improve Electronic Payment Strategies: CLD will develop and implement an outreach strategy to ensure effective use of Electronic Federal Tax Payment System (EFTPS) and will ensure that key messages related to the effective use of EFTPS are consistently delivered to appropriate stakeholders at the local level. We will also implement a strategy to incorporate the Levy/Compliance initiative into outreach with state banking institutions and credit unions and ensure that key messages are delivered.

Improve Systems, Support Structures, and Productivity to Enhance the Efficiency and Effectiveness of Operations: We will improve the Field Collection casework selection process to ensure appropriate balance between priorities while maximizing the use of revenue officer skills. This entails enhancing the skills transfer processes, training, casework selection, consistency and quality of work. We will develop a process to maximize skills knowledge transfer to less experienced employees in both managerial and professional roles. Training programs will be identified and developed timely to maximize job knowledge skills for all Field Collection employees.

Systemic levy monitoring, lien monitoring and issuance programs will be implemented. We will utilize process improvements for monitoring Manually Monitored Installment Agreements (MMIA) / In-Business Trust Fund (IBTF) installment agreements. A toll-free telephone system for MMIA/IBTF customers will be established. The electronic lien filing and electronic lien payment processes will be promoted to county recorder offices.

ACS and Compliance Services Collection Operation (CSCO) inventory issued for assignment will be improved to ensure appropriate risk level. ACS and CSCO inventory needs, inventory available, inventory in process, and plan closures will be regularly analyzed. ACS and CSCO Case management technology will be used to enhance our ability to determine the next best case to work and match that case to the appropriately skilled employee. Workload management systems will be implemented to provide the analytical tools and services to allow SB/SE managers to predict and adjust workload volume, develop operational plans, make resource decisions, and set workload priorities.

Leverage Available Technology; Identify and Secure New Technology: We will capitalize on currently available technology, find ways to better integrate existing systems, and implement new systems to streamline processes. We will promote and encourage technology strategies that will:

- Assess and identify the availability of new technology and equipment to improve existing systems and provide better access to data
- Identify and assess the usefulness of new technology with the potential to improve the efficiency of the Field Collection operations
- Encourage Revenue Officers' to better utilize existing technology, such as the internet, to enhance their effectiveness.

Technology Investments

Electronic Installment Agreement (e-IA): The e-IA application will offer an on-line web based IA application that offers new functionality through modernized tools consistent with the E-Government initiative. Our objectives are to have taxpayers self qualify, apply for and receive notification of IA approval during an on-line Internet session. Over 90 percent of taxpayers who qualify for an IA will be able to initiate and secure IA approval via irs.gov. This project will reduce IA processing costs (compared to manual processing) and will facilitate earlier taxpayer compliance by providing available service to taxpayers practically 24/7. Taxpayers will know in real-time if their IA request is approved and the IA will be established while the taxpayer is on-line. Payments (including applicable penalties and interest) will start sooner thus benefiting the taxpayer and IRS accounts receivable.

Universal Case History (employee access to complete taxpayer history): This project will provide a complete view of the taxpayer across multiple data sources, databases, and business lines with the ability to associate electronic imaged correspondence, checks and

related documents. This will decrease the amount of cycle time that a caseworker spends resolving case issues, thereby increasing the number of cases worked in the same timeframe.

Expand Compliance Date Warehouse (CDW): This project will construct a data repository that links taxpayer characteristics (return data), third party information (assets, other debts, etc.), treatment activities, and taxpayer/third party responses to those treatments along with resolution information (payments, abatements, etc.). This related data would assist the IRS in determining more effective case resolution activities decreasing cycle time and increasing revenue.

Pre-Populated Collection Information Statement (PCIS): This project will provide ability to extract third party financial information from various sources to pre-populate financial statements in balance due cases (individual and business). This will decrease the amount of time (cycle time) that a caseworker spends determining the taxpayer's financial condition and locating assets.

Consolidated Decision Analytics – Inventory Delivery System (IDS) Enhancement: This project will provide a consistent, flexible and integrated tool for case identification, selection and assignment. It will be built on existing tools and best practices and use internal/external data, experiences of subject matter experts (SMEs) and computer models. The project will increase revenue by focusing limited resources on those cases with the highest collection potential.

Electronic Filing of Federal Tax Liens (e-Lien): This project will allow for Notice of Federal Tax Liens (NFTL) and Certificates of Release to be filed electronically. NFTL recording data will be received electronically and uploaded to the Automated Lien System (ALS). This will facilitate the filing of Federal Tax Liens attaching taxpayer assets earlier in the collection process.

STRATEGY: IMPROVE FILING COMPLIANCE

To effectively improve Filing Compliance SB/SE must continuously impact and improve the voluntary compliance of SB/SE taxpayers using an appropriate balance of enforcement and non-enforcement techniques. The task is to help taxpayers understand their tax obligations and to make it easier for them to participate in the tax system. SB/SE must inform and educate taxpayers about their tax obligations in order to lessen their burden in complying with tax filing, reporting and paying requirements. Since many small business and self-employed customers face complex tax issues, they often turn to tax professionals for assistance. It is imperative to engage and educate the payroll and practitioner community and stakeholder organizations to ensure compliance with the tax laws and positively influence taxpayer behavior. The following priorities and Technology Investments will focus SB/SE efforts to successfully improve voluntary filing compliance.

Improve Filing Compliance	
Priority	Technology Investment
Implement a Comprehensive Multi-Functional Nonfiler Strategy	Business Master-File Case Creation Non-Filer Identification Process (BMF CCNIP)
Increase Electronic Interactions	
Develop and Deliver Innovative Strategies to Identify and Meet Stakeholder and Practitioner Needs	
Develop Issue Management	

Priorities

Implement a Comprehensive Multi-Functional Non-filer Strategy: We will implement a comprehensive multifunctional non-filer strategy that will focus on:

- Improving identification of non-filers
- Enhancing outreach and educational efforts and
- Developing a compliance program designed to promote current and sustained return filing through appropriate balanced compliance measures.

In the campuses, we will implement and support a compliance program that promotes current and sustained Align Automated Substitute for Return (ASFR) systems to enable integration with other programs. CLD will ensure that key messages are delivered in the non-filer strategic communications plan through national practitioner and stakeholder liaison activities. A strategy to provide educational information to practitioners and industry/business stakeholders at the national level will be developed and implemented. CLD's Centralized Data Unit (CDU) will identify non-compliant behaviors and CLD will use this information to develop and deliver appropriate messages during national liaison activities.

Increase Electronic Interactions: We will provide taxpayers and practitioners electronic access to tools, applications and software products to allow them to search intelligently and obtain tax law guidance, to create customer and contact preferences, and to use cyber assistance to fill out forms, query status information, and make simple revenue-neutral corrections and updates to account information. An integrated strategic communications plan will be developed to enhance electronic interactions with business taxpayers, including e-file.

Develop and Deliver Innovative Strategies to Identify and Meet Stakeholder and Practitioner Needs: CLD will develop and implement strategies to:

- Provide educational information to practitioners and industry/business stakeholders at the national level using data retrieved through the NRP
- Analyze practitioner and stakeholder needs and develop and deliver necessary products and services to address those needs.

We will promote the requirements of Circular 230 and conduct other actions to hold the tax practitioner community accountable for their actions. The Government Liaison Date Exchange Program (GLDEP) will enhance data sharing with state taxing organizations and will continue to support the testing and implementation of electronic data exchange with state tax partners through the EDE program.

Develop Issue Management: We will promote issue management systems that will enhance knowledge and ensure appropriate development of issues and provide the analytical tools and services necessary to support both manual and automated establishment of and adjustment to issue detection criteria and thresholds. At the front line ranks, we will identify issues adversely impacting the taxpayer and elevate those issues to the appropriate managerial level. CLD will use the Issue Management and Resolution System (IMRS) to track, resolve and analyze concerns to identify filing trends.

Technology Investments

Business Master-File Case Creation Non-Filer Identification Process (BMF CCNIP): This project will provide the ability to use information return documents in order to better identify business non-filers. This will assist the IRS in focusing its limited resources in identifying those business taxpayers who are liable but did not file a tax return.

CROSS-CUTTING COURSES OF ACTION

Some of SB/SE's FY 2006 priorities are addressed not to one specific Tax Gap area but rather represent courses of action that are fundamental or supportive of improvements in all three components of the Tax Gap. To achieve the goal of ultimately reducing the Tax Gap and improving reporting, payment and filing compliance, SB/SE must do a better job of improving our level of customer service, enhancing employee engagement and reducing taxpayer burden. The following priorities will focus SB/SE efforts to successfully impact SB/SE's overall ability to improve compliance.

Priorities Common to Reporting, Payment and Filing Compliance	
Priority	Technology Investment
Improve Customer Service	Electronic Installment Agreements (e-IA)
Enhance Employee Engagement, Recruitment, Retention, Refreshment and Development	Issue Management and Resolution System
Enhance Data Security and Protect Sensitive Information	Automated Freedom of Information Act (AFOIA)
Expand Embedded Quality	Campus Embedded Quality System
Maintain a consistent and coordinated approach to a burden reduction program that meets customer needs	Contact Recording
Ensure Accomplishment of the SB/SE EEOC 715 Plan	

Priorities

Improve Customer Service: We will continue to gain an understanding of and focus on addressing concerns identified by customers in the transactional surveys. Examinations will be conducted as expeditiously as possible after filing and we will take timely and appropriate actions on cases and customer inquiries. We will work to keep taxpayers and their representatives informed of case status through final resolution. We will provide taxpayers and their representatives with clear and accurate explanations of reports, adjustments, and available options that can be used to resolve issues. Examinations will be targeted to potential areas of non-compliance to ensure each return is substantially correct.

We will develop issue-specific explanations of adjustments and requested substantiation/ documentation via Form 886-A for Schedule A deductions and Schedule C expenses. Quality standards will be linked directly to employee Critical Job Elements (CJE) to enable employees to see how individual performance impacts SB/SE objectives.

All Fraud Program efforts will be coordinated with key stakeholders and customers through regular open and honest communication and joint planning to meet mutual objectives for enforcement of the tax law. We will establish standard operating procedures to provide increased consistency, efficiency, and effectiveness of the administration of the Fraud Program. Surveys will be developed and administered to monitor the level of customer satisfaction, and data will be collected and analyzed to improve customer service, and enhance technical and procedural content and overall effectiveness of the Fraud Web Site.

We will make electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer these methods to calling and mailing. We will promote www.irs.gov, and specifically "electronic-IRS", as the resource to provide easy access for taxpayers and tax professionals to obtain information and self-help tools. We will increase awareness for e-filing extensions (continue e-filing volume beyond April 17th) and e-file as it relates to business returns. We will deliver the 2006 Key Messages for the electronic-IRS campaign:

For Tax Professionals...

- The IRS is making it easier for you to conduct business electronically
- The growing trend is clearly toward electronic filing and paying
- Electronic filing and paying can help you solidify client relations.

For Taxpayers...

- Ask your tax professional about filing and paying electronically
- Filing and paying electronically gets taxes done more accurately, quickly and efficiently and gets refunds sent back faster, especially with direct deposit
- Electronic filing and paying ensures that your tax information arrives and that your history is safe and secure.

Enhance Employee Engagement, Recruitment, Retention, Refreshment and Development: We will adopt and implement appropriate policies and procedures at all levels of the organization to instill an organizational culture that is dedicated to enhancing employee engagement and accountability. Balanced measures of performance will be incorporated into regular workgroup discussions throughout all levels of the organization. Managers use the workgroup meeting process to:

- Ensure that all their employees understand what is expected of them, how their work relates to the Agency's missions and goals and the importance of their work
- Highlight their workgroup's success and challenges while developing solutions for identified barriers to goals and objectives.

A strategic approach to enhancing employee engagement will be developed and implemented throughout SB/SE. A process of accountability will be established that requires:

- Every manager to have a separate employee engagement commitment
- All executives and mid-level managers to include information concerning the engagement discussions, actions and implemented solutions in their operational reviews of subordinate managers
- Senior Leadership to review high and low scoring workgroups to identify best practices that can be shared, systemic barriers to resolve and to assist workgroups toward improving their employee engagement results.

We will continue to enhance and improve the hiring and training of new employees by redesigning recruiting efforts, training materials and training delivery methods.

Recruitment strategies for planned hiring will be implemented to maximize the opportunity period to identify and assess qualified candidates and increase the candidate pool. Training will be provided to address current knowledge needs at all levels thereby increasing job satisfaction and employee retention. We will focus on improving skill sets to compensate for personnel losses due to retirement, attrition, and migration to other business units. The effectiveness of current training delivery methods will be assessed and a clear direction for future training will be established.

Enhance Data Security and Protect Sensitive Information: We will ensure that all employees are in full compliance with all IRS equipment and data security requirements. It is critically important that any sensitive files be immediately put into an encrypted state when not in use. The following actions must be adhered to regardless of employee's post of duty:

- All taxpayer information, private information, names with associated social security numbers, employee evaluations, procurement documents and anything else that fits a broad category of "sensitive" must be removed or properly encrypted
- Managers must verify that every employee understands how to use the IRS encryption software
- Managers must verify that every employee review all data on their laptop or other portable media storage devices, and if sensitive information is not specifically needed in the performance of duties, then that sensitive information must be removed
- Managers must verify that every employee understands his or her responsibility to properly protect all sensitive information on a laptop or other portable media storage devices including protection of IRS IT equipment while out of the office in a travel status. Laptops are never to be checked in with luggage on a commercial flight or left unattended at audit sites or other remote locations.

SB/SE has set up a special computer data security web site that provides information and guidance to assist employees in complying with all IRS data security requirements. Also, SB/SE's Business Systems Planning (BSP) organization will be available to answer all questions regarding data security requirements.

Expand Embedded Quality: Embedded quality will be expanded into additional programs and functions. We will implement the infrastructure and assess functionality of merged quality review systems. We will focus on increasing the emphasis on building quality into day-to-day compliance activities. Quality will be measured at the front-line where timely improvements to processes can be instituted. We will fully implement and effectively use the Embedded Quality concept. The Quality Improvement infrastructure development (Quality Improvers) will be evaluated in recommending continuance of the program.

A National Quality Review Staff for Specialty Programs will be implemented to identify quality concerns as early in the examination process as possible and work to initiate resolutions to any deficiencies. We will pilot Embedded Quality for (Specialty) Examination and Collection and rollout to front-line managers in all compliance programs.

Maintain a consistent and coordinated approach to a burden reduction program that meets customer needs: We plan to reduce the burden on taxpayers by improving level of service and using customer feedback to identify improvement opportunities. The Office of Taxpayer Burden will continue to:

- Simplify tax forms, publications and notices
- Revise or develop tax forms and publications, based on changes in laws and regulations
- Streamline internal policies, processes and procedures
- Promote less burdensome rulings
- Promote the identification and resolution of issues that require changes in laws, regulations, rules, or procedures and significantly reduce burden for taxpayers/preparers
- Develop a more accurate and reliable burden measurement methodology and model.

CLD will also partner with internal and external stakeholders to more effectively and efficiently identify and address burden reduction initiatives. Key messages and products related to approved stakeholder or taxpayer burden issues will be developed. We will ensure effective and timely communications with key stakeholder groups.

Ensure Accomplishment of the SB/SE EEOC 715 Plan: We will modify affirmative employment programs that impact SB/SE human capital strategies based on identified barriers, new legislation and other emerging EEO issues. We will also:

- Strengthen Operating Unit involvement in the development and delivery of the MD-715 action items
- Develop a strategic, multi-year Federal Agency Annual EEO Program Status Report (MD-715) to allow for more measurable results through effective identification of root causes along with a more extensive barrier analysis and elimination process
- Identify significant trends, issues and problems and provide advice and guidance during settlement negotiations, the reasonable accommodation process, and other program areas
- Perfect and provide data analysis and support to each OU for Operational Reviews including costs and other requirements associated with the No Fear Act.

The EEO and Diversity office will provide data analysis to the field level, and ensure early identification of the proper management officials for participation during Alternate Dispute Resolution (ADR) or formal settlement discussions. They will work with SB/SE

managers to resolve workplace issues that result in allegations of unlawful discrimination and continue to promote ADR/mediation at the informal and formal stage of the EEO complaint process. Measures will also be developed to monitor improvement in this area.

Technology Investments

Electronic Installment Agreement (e-IA): The e-IA is an on-line web based IA application that offers new functionality through modernized tools consistent with the E-Government initiative. Taxpayers will be able to self qualify, apply for and receive notification of IA approval, during an on-line Internet session. Over 90 percent of taxpayers who qualify for an IA will be able to initiate and secure IA approval via irs.gov. This project will reduce IA processing costs (compared to manual processing) and will facilitate earlier taxpayer compliance by providing available service to taxpayers practically 24/7. Taxpayers will know in real-time if their IA request is approved and the IA will be established while the taxpayer is on-line. Payments (including applicable penalties and interest) will start sooner thus benefiting the taxpayer and IRS accounts receivable.

Issue Management Resolution System (IMRS): This system is a web-based application that will allow SB/SE to proactively gather data on issues, detect trends, monitor issues, and provide resolutions and communication with greater efficiency. Analysis will be conducted to identify nationwide trends. This data will be shared with the other Operating Divisions and functions on a regular basis. Progress on resolving issues will be closely monitored to assure timely resolution of stakeholder issues and communication of the resolution to the initiating stakeholder and all impacted stakeholders.

Automated Freedom of Information Act (AFOIA): AFOIA is an imaging application originally developed to meet the statutory requirements for disclosure of agency records to the public under the Freedom of Information Act (FOIA). This COTS product has been customized to meet all GLD business requirements as a data repository and document management system. Using the automated workflow routing capabilities, GLD Disclosure Offices will migrate from a paper environment to fully electronic case files for disclosure requests received under IRC 6103, FOIA and the Privacy Act.

Campus Embedded Quality (EQ): This project will expand the Embedded Quality Review System (EQRS) to include new Specialized Product Review Groups (SPRGs) for SB/SE products. In August 2007, MITS is scheduled to deliver four new SPRGs for Centralized Insolvency Paper and Phones and Centralized Case Processing Liens Paper and Phones. This delivery will add new review attributes, header fields and reports to EQ. A subsequent EQ update, delivery date to be determined, but not sooner than FY 08, will include additional SPRGs for SB/SE campus work products.

Contact Recording (CR): This project, currently in use in all W&I and SB/SE telephone sites, will be updated to include enhanced real-time recording capabilities at

the individual sites and expanded, automated national sampling at the Centralized Quality Review Site (CQRS). The initial production of Ultra version 10 will be installed in January 07 and full deployment is expected in December 07.

V. ARE WE THERE YET? - MEASURES AND OUTCOMES

Success in achieving SB/SE's goals is contingent on a number of interrelated factors, such as employee engagement, customer satisfaction, business results, and stakeholder relationships. These factors must be monitored regularly to assist managers in making program decisions that will impact achievement of organizational goals. Quantitative performance measures are essential to the proper operation of any large organization. Management at all levels, both internal and external to SB/SE and to the IRS, use performance measures and goals to indicate whether a program is performing effectively.

Measures and indicators have been developed throughout the organization to help managers and employees see the big picture of where we are headed and to ensure achievement of our goals. Our measures are aligned at all levels of the organization, from Servicewide measures that are reported to Congress to workgroup indicators used by group managers. We report our progress on a regular basis to a number of different stakeholders, both internal and external, such as:

- Congress
- Treasury and OMB
- IRS Oversight Board
- IRS Commissioner Everson and Deputy Commissioner Matthews
- CFO

Since each of these stakeholders have different interests in our progress, not all measures and indicators are reported to each group. Instead, we have identified different level measures used to report to different groups:

- **Enterprise Measures** – Servicewide measures that combine like programs from all IRS Operating Divisions to provide an overall evaluation of performance. Include measures such as Coverage and Efficiency (OMB, Treasury, Congress)
- **Budget Level** – SB/SE National Level measures that are required to be reported in the Budget Submissions (OMB, Treasury, Congress)
- **Business Performance Review (BPR) Key Program Measures** – SB/SE critical or key measures that are required to have targets set and are reported in the SB/SE BPR (IRS Commissioner, Deputy Commissioner and Chief Financial Officer)

A complete list of SB/SE's Enterprise, Budget Level and BPR Key Program Measures is included in Addendum II.

Addendum I

FY 2006 - FY 2007

Priority Matrix

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	CDLL	CLD	TBR	EEO & Diversity
Improve Reporting Compliance								
Focus on Egregious Non-Compliance and Areas of Highest Strategic Risk Affecting the Tax Gap	Consider non-compliant work such as abusive scheme promoters, preparers and participants, non-filers and certain high-income taxpayers in the Examination Workplan	Continue to address egregious non-compliance and areas of strategic risk including: Abusive scheme participants, Return preparers, Non-filer audit referrals, and High risk inventories referred from the Field, CI, etc	Improve and refine inventory through analysis of open & closed cases and employee and taxpayer engagement	Conduct Bank Secrecy Act (Title 31) Examinations for Money Services, Casinos, Credit Unions, Insurance Industry, Dealers in precious metals, precious stones or jewels				
	Identify egregious activities through Compliance Initiative Projects (CIP) and Return Preparer Program cases appropriate for Field Examination	Monitor the campus productivity of high-risk inventories	Focus Registration activity on new registrants under the American Jobs Creation Act to generate leads for examination and to determine to what extent additional compliance efforts are needed (Ex)					
	Emphasize Schedule C activity that correlates to the tax gap	Partner with Research and W&I to profile applicable Total Positive Income (TPI) codes for potential sources of noncompliance	Devote additional SB/SE resources to identifying significant fuel tax noncompliance, Some are LMSB taxpayers and will increase our Centralized Industry Case workload (Ex)					
	Assure National Research Program (NRP) study of Sub-Chapter S Corporation cases (1120-S NRP cycle) are timely delivered, assigned, started and completed	Establish referral process for AUR cases that require analysis outside of AUR	Leverage Nationally identified noncompliance in the areas of Currency Banking Retrieval System leads, 941 nonfilers, and Corporate Officer nonrecognize (Emp)					
	Assure that NRP cases are developed to the appropriate depth for the issues identified and the associated multi-year and related return examinations are initiated and completed timely	Establish mechanism to link TPI class/prior year performance to inventory selections	Provide workload such as IRC 861 Stop Filers, PEO Employee Leasing, Tip Income, SS-8 compliance leads, and other areas to the extent it productively identifies areas of noncompliance (Emp)					
		Expand application of AUR repeater profile	Continue to address noncompliance in the area of Family Limited Partnerships being used to evade reporting & payment of Estate & Gift Taxes (E&G)					
			Maximize effectiveness by monitoring case status reports generated from LMSB Engineering to ensure appropriate development and efficient determination of significant valuation issues (E&G)					
			Improve the process of securing liens and providing research services (E&G)					

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
Optimize Examination Program Coverage	Through our National Workplan align resources & inventory to accomplish the staff years and return closures reflected in the FY 2006 Plans	Partner with W&I: To implement a corporate strategy to maximize audit coverage and results; To streamline work plan process to ensure consistent resource and inventory allocations among the campuses; To ensure successful transition to Corporate Inventory concept; and To develop measures to determine efficiency and effectiveness of partnering efforts.	Continue to provide expertise to support the Service's abusive tax shelter strategies	Conduct examinations from the corporate headquarters standpoint and establish a methodology to identify and conduct examinations in high risk geographic locations that have had no prior or only minimal coverage				
	Provide balanced coverage in the following categories: Individual returns <$100,000; Individual returns >$100,000 but <$200,000; Individual returns >$ 200,000 Small Business Corporations; and Small Business Flow-Through Entities for S Corporations, Fiduciaries, & Partnerships	Provide a balanced approach for return delivery and allocation of staffing	We will develop and implement an Employment Tax Strategy to improve employment tax compliance. The strategy will increase compliance and reduce burden of employers in the filing, reporting and payment of employment taxes.	Work with FinCEN to establish action plans and procedures to effectively address BSA compliance for the insurance industry and dealers in precious metals, gems and jewels				
		Provide screened, ready to work inventory to the campuses by Centralized DAE unit		Strengthen enforcement activities through timely detection of non-compliant entities and address non-compliance in a timely and quality manner				
		Provide the necessary resources to ensure that mandatory compliance reviews are completed, referrals are examined, and high risk entities are identified and examined		Increase productivity and reduce our no issue rate, while improving customer service and satisfaction through reductions in cycle time				
		Develop tracking methodologies to determine productivity of each identified workstream						
		Partner with W&I – AUR To streamline work plan process to ensure a consistent approach to resource and inventory allocations among the campuses; To ensure successful transition to Corporate Inventory Management Concept; and To develop measures to determine efficiency and effectiveness of partnering efforts						
		Monitor workload distribution program implemented in FY05 to ensure that workplan deliveries that match on board staffing thus facilitating timely case closure						

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
Ensure Appropriate Return Preparer Behavior		Work cooperatively with CI and Field Exam to identify practitioners who encourage taxpayers to take overly aggressive positions on their tax returns and/or do not fully cooperate to timely resolve examinations issues	Address practitioners who take overly aggressive positions on the returns they prepare or in their representation practices					
		Ensure that referrals and/or penalties are asserted when appropriate	Develop preparer penalties and refer practitioners to the Office of Professional Responsibility when appropriate					
		Recognize inappropriate behavior and return preparation practices and take action	Use practitioner behavior as an indicator in the workload identification process					
Focus on Identification of Fraud	Include cases representing the most egregious forms of non-compliance in our workplan audit coverage	Assess the impact of implementation of FY 05 Fraud Initiative and utilize the results to refine fraud identification efforts	Focus on identifying the most noncompliant taxpayers through targeted workload and "taking the right action at the right time", leading to the increase in fraud referrals	Support Service-wide development of criminal fraud referrals and civil fraud penalties				
	Consider the identification and development of fraud in all examinations	Identify as areas of focus those industries, issues and/or taxpayers who attempt to evade their responsibilities		Assist in the identification and development of potential fraud leads as well as the recommendations for injunctions and referrals to the Office of Professional Responsibility				
		Provide technical and procedural guidance in the identification and development of potential criminal fraud referrals and civil fraud penalty cases		Establish leveraged partnerships with CI, all IRS Operating Divisions and Functions to increase fraud awareness and support the fraud program objectives				
		Refine the fraud referral process						
		Coordinate efforts between the Campus Fraud Coordinators and the Area Fraud Technical Advisors (FTA) including a training workshop						
		Develop and implement standardized procedures						
		Utilize feedback from FTA, Compliance Technical Support and CI to increase the number of accepted referrals						
		Continue HQ engagement in fraud identification efforts						
		Utilize COBR monthly reporting to highlight activities and identify trends issues and problems						
		Include fraud in operational reviews by SB/SE Directors						

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
Ensure Appropriate Identification and Development of Issues	Completion of the NRP study has enabled the IRS to retool its workload identification process for the first time in over 20 years. Two major achancements in workload delivery are the new workload identification (DIF) formulas and restructuring of examination classes. SB/SE will use the new examination classes and the new workload identification formulas to refocus our enforcement efforts to areas contributing the most to the tax gap while minimizing the disruption on compliant taxpayers.	Provide tools to further develop employees' abilities to ensure appropriate development of issues.		Plan and direct BSA compliance strategies through an ongoing risk assessment process for emerging BSA compliance issues.		Identify significant issues and concerns to reduce barriers to voluntary compliance, relieve taxpayer burden, and ensure that appropriate policies and procedures are in place.		
	Continue to identify and develop more effective methods for deterring Abusive tax avoidance transactions (ATAT) activity	Develop issue specific procedures and training modules, including job aids and IRM 4.19 and 4.13 revisions/guidance		Identify issues through improved data collection, exchange of internal data, and the analysis of the data from management information systems.		Use the Issue Management and Resolution System (IMRS) to track, resolve and analyze concerns to identify compliance trends.		
	Use civil injunctions to shut down the promotion of schemes.	Develop a Campus Audit Technique Guide for Correspondence Examiners, including issue and case examples				Transmit pertinent information to Compliance, CAS and other appropriate IRS entities;		
	Ensure that high-profile convictions, sanctions, and injunctions are well publicized and ensure that enforcement measures are targeted at promoters of schemes.	Provide the analytical tools and services to support manual and automated establishment and adjustment to issue detection criteria and thresholds				Secure and develop issues from national and local practitioner and stakeholder liaison activities		
		Establish teams to evaluate/assess the completeness and effectiveness of IRM/Job Aids and Schedule C Issue Guidance				Ensure that information concerning issue resolution is conveyed to stakeholders		
		Post completed products to SERP for accessibility by all employees to enhance their learning capabilities				Ensure productive coordination of liaison activities and efficient issue management internal control		
						Monitor the effective use of the IRMS database		
						Act as liaison between the SL Field and other functions to resolve the issues		
						Generate reports as necessary on trends and results identified from the IRMS process		
						Build working relationships with other "suggestion" programs to ensure a regular sharing of issues, problems, and suggestions from all sources		
						Use the Issue Identification and Resolution System (IIRS) to identify and elevate technical issues that have IRM or policy implications a track the status of their resolution		
						Use the Disclosure Dispatch newsletter to disseminate policy and procedure changes to all Disclosure employees		

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
Increase Efficiency and Effectiveness of Operations through Improved Inventory, Workload and Resource Management	Monitor and analyze inventory needs, inventory available, and inventory in process and plan closures in a regular basis	Ensure inventory is available when needed and delivered timely to support workplan needs	Ensure examiners secure the related returns necessary to ensure compliance	Identify entities at the highest risk for BSA noncompliance using an enhanced workload identification system		Improve inventory management by focusing on the integrity of the Electronic Data Inventory Management System (E-DIMS)		
	Redirect inventory if shortages of resources occur to deliver a balanced plan	Deliver inventory to support developed work schedule and training plans	Establish new and redesigned Examination processes/procedures as the "norm" for our compliance personnel and determine if further refinement or modification is warranted	Improve case building through increased access to researchable electronic data				
	Coordinate inventory brokering within an Area and between Areas if necessary	Identify campus inventory to meet FY 2007 workplan targets	Make a critical assessment of The Centralized Excise Operation work processes with the objective of adding additional value to field work, or potentially taking over tasks previously performed in the field	Improve the accuracy, reliability, and accessibility of data through enhancements to our management information systems				
	Reduce overage and cycle time and minimize hours per return and multiple-year and related return examinations to minimize taxpayer burden and improve efficiency and compliance	Provide the analytical tools and services to allow SB/SE managers to predict and adjust workload volume and develop operational plans, make resource decisions, and set workload priorities						
	Increase productivity through more effective utilization of time, while maintaining a high level of quality on our cases	Implement centralized workload selection and delivery						
	Conduct RA examinations at the taxpayers' premises whenever possible to increase productivity	Focus resources to balance the delivery of workplans to achieve return closures						
	Use risk analysis tools like 80/20 and provide effective managerial involvement at all levels to achieve goals	Provide a more effective and efficient workload identification and selection process						
	Continue efforts to refine the examination process	Work with Research to identify inventory characteristics by activity code that are conducive to the Correspondence Exam process						
	To ensure inventory is available and delivered to support the Examination workplan needs, all work, except for multiple-year and related return examinations, will be obtained through the PSP Offices	Improve the ability to identify and select the most productive cases for examination						
		Partner with W&I to identify and select MACS inventories for the campus based on potential productivity (next best case)						
		Conduct regular analysis of inventory needs, available inventory, inventory in process, and plan closures						
		Monitor inventories delivered relative to planned new starts by campus						
		Conduct monthly analyses of remaining inventory needs by campus and inventory available						

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
Communicate strategic compliance initiatives to internal and external (private, state and federal) stakeholders						Develop and implement a strategy to ensure information related to strategic compliance initiatives is consistently communicated to practitioners and industry/business stakeholders through well-planned liaison activities, including information related to non-bank financial transactions and international issues		
						Identify tax professional and other partners most critical to influencing reporting compliance and work with Communications to identify, develop and deliver appropriate messages through leveraged communications opportunities		
						Consistently deliver key policy and procedural messages related to strategic compliance initiatives to practitioners at the local level, including information related to non-bank financial transactions and international issues		
						Work with the state taxing authorities to maintain and improve upon our existing partnership relations, to identify productive uses of leads, ensuring the states have the opportunity for training, as appropriate, and to share Revenue Agent Reports (RARs) early in the process		
						Maintain, through their Congressional Affairs Program, a proactive liaison with congressional offices on key issues		
						Ensure that Freedom of Information Act (FOIA) requests for background records concerning areas of egregious non-compliance are properly coordinated		
						Work with Large and Mid-sized Business (LMSB) to develop processes for sharing information, pursuing emerging issues on tax shelters, and identifying joint training opportunities		
						Ensure that CLD actions are aligned with and in support of SB/SE and IRS goals through the planning and monitoring process		

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
Improve Payment Compliance								
Positively Impact Potentially Collectible Inventory					Improve the currency of Field Collection inventory (reduce overage and potentially overage accounts) by focusing on: Better workload management practices; Working cases strategically by taking simultaneous actions where possible; Improve response time on TAS issues			
					Improve compliance of in-business taxpayers: Take steps to minimize pyramiding of taxpayer accounts; Improve monitoring of taxpayer compliance; Strengthen the Federal Payment Levy Program			
					Improve Field Collection casework quality by focusing on: More effective analysis of financial information; Better identification of the correct case closing type; Improving the accuracy of our collectibility determinations			
					Continue to evaluate and streamline the current processes to enhance Field Collection effectiveness			
					Leverage the unique skills of Field Collection and increase field time thereby closing more case, collecting more dollars and improving overall compliance			
					Increase the timely pursuit and appropriate application of complex enforcement tools such as seizures, nominee liens, transferee assessments and suits to protect the government's interest in liabilities owed			
					Improve the insolvency program's use and timeliness of administrative and judicial remedies to promote compliance of bankrupt taxpayers			

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
					Continue to enhance our ability to collect from delinquent Federal contractors using both technology and improved casework			
					IRS collection information statements will be amended to specifically ask taxpayers if they perform work for the Government			
					Systemic changes scheduled for January 2007 will add an indicator to the Integrated Collection System to alert revenue officers when a taxpayer is listed by the General Services Administration as having received a Federal contract			
					Contractors meeting certain criteria will be assigned to revenue officers in Abusive Tax Avoidance Transaction groups so that the enhanced investigative skills of those groups can be used to collect from this highly visible taxpayer segment			
					Because Federal contractor cases have been identified as a business priority, all such cases will be reviewed by managers at least once every six months as part of the Collection Consultative Initiative, in which managers and revenue officers discuss priority cases and develop collection strategies			
Improve Field Collection's Ability to Address Complex Payment Avoidance Tactics					Expand field Collection's ability to handle multi-dimensional complex casework - Collaborate as appropriate with other stakeholders such as Counsel, Appeals and TAS			
					Incorporate emerging Examination Compliance Initiatives into Field Collection planning and workload delivery processes			
					Enhance our ability to develop quality fraud referrals by improving fraud recognition and coordination with Exam, BSA and CI			
					Determine impact of e-commerce non-compliance on the Field Collection workload			
Increase and Improve Electronic Payment Strategies						Develop and implement an outreach strategy to ensure effective use of EFTPS will implement a strategy to incorporate the Levy/Compliance initiative into outreach with state banking institutions and credit unions		
						Consistently deliver key messages related to the effective use of EFTPS to appropriate stakeholders at the local level, and deliver key messages to banking institutions and credit unions in line with the corporate strategy regarding the Levy/Compliance initiative		

Priority	EXAM	Actions by program area						
		COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
Improve Systems, Support Structures, and Productivity to Enhance the Efficiency and Effectiveness of Operations		Utilize process improvements (DAE process) for Manually Monitored Installment Agreements (MMIA), Un-Business Trust Fund (BTF) installment agreements monitoring and establish a tool maintained	Establish new and redesigned Collection processes/procedures as the "norm" for Field Collection owners and delete "norm" further refinement or modification is		Improve the Field Collection casework selection process to ensure appropriate taxpayer issues are addressed while maximizing the use of revenue officer skills			
		Continue system enhancements of the Automated Lien System (ALS) which includes ensuring RIS submissions are completed timely			Develop a process to maximize skills knowledge transfer to less experienced employees in both managerial and professional roles			
		Implement systemic levy monitoring, lien monitoring and issuance programs			Identify and deliver timely training programs to maximize job knowledge skills for all Field Collection employees			
		Provide electronic lien filing and electronic lien payment process with county recorder offices			Improve the consistency, quality, and level of responsiveness provided by Advisory			
		Participate in IDS delivery						
		Keep pace with high priority work received by the field						
		Provide educational presentations during group meetings on procedural issues, and ensure managerial review of cases to effectively address the main issues identified Compliance Field Policy's operational review						
		Support managers with appropriate tools to provide encouragement, guidance, accurate feedback and assistance to field						
		Improve ACS and CSCO inventory issued for assignment, ensuring appropriate risk level						
		Use case management technology in ACS and CSCO to provide the ability to determine the best best case to work and match that case to the appropriately skilled employee						
		Develop workload management systems to provide the analytical tools and services to allow SB/SE managers to predict and adjust workload volume and delegate projected work, make resource decisions, and set workload priorities						
		Provide real time monitoring of call demand and activate appropriate strategies to optimize staffing levels in the call sites						
		Decrease management overhead and refocus resources to frontline customer facing activities						
Leverage Available Technology; Identify and Secure New Technology					Assess the role of current technology and appropriate vendor sources to ensure we maximize its potential			
					Initiate efforts to better integrate existing systems			
					Implement new technology that will enable us to streamline current Field Collection processes			

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
Improve Filing Compliance								
Implement a Comprehensive Multi-Functional Nonfiler Strategy		Implement and support a compliance program that promotes current and sustained return filing through appropriate balanced compliance measures				Support the Servicewide non-filer strategy by delivering key messages in the non-filer strategic communications plan through national practitioner and stakeholder liaison activities		
		Align ASFR systems to enable integration with other programs				Develop and implement a strategy to provide educational information to practitioners and industry/business stakeholders at the national level using data retrieved through the National Research Program (NRP)		
		Deliver High priority work/ high income nonfiler cases				Collaborate with CLD's Centralized Data Unit (CDU) to identify non-compliant behaviors and use this information to develop and deliver appropriate messages during national liaison activities		
Increase Electronic Interactions						Provide taxpayers and practitioners electronic access to tools, applications and software products to allow them to search intelligently and obtain tax law guidance, to create customer and contact preferences, and to use cyber assistance to fill out forms, query status information, and make simple revenue-neutral corrections and updates to account information		
						Collaborate with SB/SE business owners to create an integrated strategic communications plan to enhance electronic interactions with business taxpayers, including e-file		
						Partner with Communications to develop innovative web services which meet the needs of practitioners and stakeholders		
						Deliver key messages regarding electronic interactions through liaison activities at the local level		
Develop and Deliver Innovative Strategies to Identify and Meet Stakeholder and Practitioner Needs						Develop and implement a strategy to provide educational information to practitioners and industry/business stakeholders at the national level using data retrieved through the National Research Program (NRP)		
						Partner with SL Field to develop and implement a feedback strategy analyzing practitioner and stakeholder needs Using this information, partner with Communications to develop and deliver products and services addressing those needs		
						Deliver key messages regarding data retrieved through the NRP to practitioners through well-planned practitioner liaison activities at the local level		

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
						Develop a pilot, in partnership with GLD, to use their new business data to develop an outreach strategy targeting new businesses. Evaluate the pilot to determine the value of a nationwide rollout		
						Partner with SL HQ to develop and implement a feedback strategy analyzing practitioner and stakeholder needs. Deliver products, developed from this feedback, through well-planned liaison activities at the local level		
						Promote the requirements of Circular 230 and conduct other actions to hold the tax practitioner community accountable for their actions		
						Enhance data sharing through the Government Liaison Data Exchange Program (GLDEP) with state taxing organizations, and continue to support the testing and implementation of electronic data exchange with state tax partners through the Electronic Data Exchange (EDE) program		
						Take the lead in working with operating divisions to develop a strategy for use of state data (TIGTA audit recommendation)		
						Continue the development of mutually beneficial relationships with all State Workforce Agencies (SWA) with the goal of implementing initiatives and database exchanges to support compliance business objectives		
						Continue to collaborate with state agencies to obtain state RARs		
Develop Issue Management		Implement the Issue Resolution Tracking System (IRTS)				Collaborate with the Issue Management Project Manager to evaluate issues related to improving products and services to stakeholders. Incorporate this information into new products and services in collaboration with Communications		
		Provide the analytical tools and services to support manual and automated establishment and adjustment to issue detection criteria and thresholds				Use the Issue Management and Resolution System (IMRS) to track, resolve and analyze concerns to identify filing trends		
		Identify issues at the front line ranks adversely impacting the taxpayer						
		Elevate those issues to the appropriate managerial level and evaluate quality of issues elevated						

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TSR	EEO & Diversity
Priorities Common to Reporting, Payment and Filing Compliance								
Improve Customer Service	Review and analyze the verbatim comments to identify customer perspective issues	Reduce overage and cycle time and improve quality of work on cases	Take timely and appropriate actions on cases	Provide case direction that results in effective and efficient development of potential fraud issues	Develop processes and/or guidance that more effectively resolves their tax issues	Collaborate with appropriate business owners to develop outreach products targeted towards sectors of greatest non-compliance		
	Ensure that returns are examined by employees with the required level of expertise for the particular issues	Take timely and appropriate actions on cases and customer inquiries	Keep taxpayers informed of case status up through resolution of the issues	Establish standard operating procedures to provide increased consistency, efficiency, and effectiveness of the administration of the Fraud Program	Develop processes and/or guidance that more effectively communicates to the taxpayer the status and/or resolution of their accounts by focusing on more timely follow-up actions and reducing activity lapses	Develop and implement a strategy to deliver key messages through liaison activities		
	Support internal customers and collaborate and cooperation with other operating and business units to support operational priorities	Increase productivity through more effective utilization of time while maintaining a high level of quality on cases	Provide clear and accurate explanations of reports and adjustments including options for resolution	Develop and administer surveys to monitor the level of customer satisfaction, collect and analyze customer satisfaction data to improve customer service, and enhance technical and procedural content and overall effectiveness of the Fraud Web Site	Develop processes and/or guidance that ensure that revenue officers consider all available options in resolving taxpayer accounts	Determine appropriate liaison channels and activities in order to consistently implement the delivery of key messages targeting identified sectors of non-compliance		
	Conduct examinations as expeditiously as possible after filing, actions on the case need to be timely and appropriate	Develop a Campus Audit Technique Guide for Correspondence Examiners, including issue and case examples		Transition from a success measure of time accomplishments to a broader spectrum of metrics		Conduct routine focus groups at the national and local levels with practitioners and stakeholders		
	Keep taxpayers and their representatives informed of case status through resolution	Study and utilize time weight factors as a component of the inventory selection process		Improve the timeliness of examinations, professionalism of our staff, and the quality of interaction with our BSA customers		Develop and/or implement quality standards for all CLD casework products, and an on-going post-closing quality review process		
	Provide taxpayers and their representatives with clear and accurate explanations of reports, adjustments and available options that can be used to resolve issues	Expand the use of Auto notice – AUR		Use comprehensive data obtained through manager concurrence meetings, enhanced engagement with our examiners, and improved use of metrics to provide balanced and fair enforcement		Conduct post-closing quality reviews of compliance cases and use the results to develop awareness products for compliance employees		
	Target examinations to potential areas of non-compliance to ensure each return is substantially correct	Monitor inventory to ensure actions are being taken timely and in accordance with Action 81 guidelines		Set the proper scope and depth of examinations and include the standardized issuance of Letter 1112, Report of Apparent Violations		Provide IRS employees with essential disclosure awareness products and services		
		Provide follow-up actions and guidance relative to the Professional Decision Making (PDM) training		Consider burden and how it will assist in the examination for compliance prior to requesting records, preparing schedules or creating databases		Develop and oversee the new FedFed Program to facilitate and maintain the Service's relationships with other federal agencies through increased partnerships, data exchanges, and involvement in compliance initiatives		
		Keep taxpayers and their representatives informed of case status, through resolution		Coordinate all Fraud Program efforts with key stakeholders and customers through regular open and honest communication and joint planning to meet mutual objectives for enforcement of the tax law		Collaborate with Mission Assurance and Security Services (MA&SS) and Wage and Investment (W&I) to provide technical guidance relative to identity theft and safeguarding of confidential tax information		
		Provide clear and accurate explanations of reports, adjustments, and available options				We will make electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer these methods to calling and mailing		

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
		Develop issue-specific explanations of adjustments and requested substantiation documentation via Form 886-A for Schedule A deductions and Schedule C expenses				We will promote www.irs.gov, and specifically "electronic-IRS", as the resource to provide easy access for taxpayers and tax professionals to obtain information and self-help tools		
		Link quality standards directly to employee Critical Job Elements (CJE) to enable employees to see how individual performance impacts SB/SE objectives				We will increase awareness for e-filing extensions (continue e-filing volume beyond April 17th) and e-file as it relates to business returns		
		Evaluate the potential effectiveness of using bar code scanners to improve Exam Closing Processes				We will deliver the 2006 Key Messages for the electronic-IRS campaign:		
		Improve Centralized Case Processing (CCP) cycle time				For Tax Professionals ... □ The IRS is making it easier for you to conduct business electronically. □ The growing trend is clearly toward electronic filing and paying. □ Electronic filing and paying can help you solidify client relations.		
		Implement Contact Recording for Centralized Insolvency				For Taxpayers... □ Ask your tax professional about filing and paying electronically. □ Filing and paying electronically gets taxes done more accurately, quickly and efficiently and gets refunds sent back faster, especially with direct deposit. □ Electronic filing and paying ensures that your tax information arrives and that your history is safe and secure		
		Establish appropriate level of service (LOS) targets for Centralized Insolvency phone operation (David will follow up on)						
Enhance Employee Engagement, Recruitment, Retention, Refreshment and Development	Managers use the workgroup meeting process to: ▶ Ensure that all their employees understand what is expected of them, how their work relates to the Agency's missions and goals and the importance of their work ▶ Highlight their workgroup's success and challenges while developing solutions for identified barriers to goals and objectives							
	Establish a process of accountability that requires: ▸ Every manager to have a separate employee engagement commitment ▶ All executives and mid-level managers to include information concerning the engagement discussions, actions and implemented solutions in their operational reviews of subordinate managers ▶ Senior Leadership to review high and low scoring workgroups to identify best practices that can be shared, systemic barriers to resolve and assist workgroups toward improving their employee engagement results							
	Listen to the concerns of our workforce for opportunities to reduce burden and improve the circumstances critical to the Examination team	Implement recruitment strategies for planned hiring to maximize the opportunity period to identify and assess qualified candidates and increase the candidate pool	Identify the proper areas of strategic risk, and provide an environment where our employees can be productive	Provide FTAs with appropriate tools and training to maximize their productivity, quality and job satisfaction	Provide Field Collection employees with the necessary resources to effectively perform their jobs	Promote a work environment that optimizes employees' talents and encourages employees to excel		
	Deliver face-to-face CPE for Examination technicians	Target hiring initiative at experienced, mid-career employees and revise training programs to accommodate this hiring pool	Explain strategic direction, workforce roles, and seek input on whether we are headed on the right course	Track work trends and assess skills to ensure that proper employee skill sets are available to staff current and projected initiatives	Identify employee issues and concerns and take appropriate steps to address	Communicate successes throughout CLD		
	Continue to enhance and improve the hiring and training of new employees by redesigning our recruiting efforts, training materials and training delivery methods	Provide training to address current knowledge needs at all levels thereby increasing job satisfaction and employee retention		Implement hiring and retention programs to ensure a diverse workforce and appropriate staff levels to meet customer needs	Conduct analysis of the revenue officer occupation, including the skill sets needed to do the job now and in the future	Identify training needs and opportunities to enhance employee knowledge and skills		

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
	Address employee satisfaction as the key to improving employee engagement	Focus on improving skill sets to compensate for personnel losses due to retirement, attrition, and migration to other business units		Offer employees a modern work environment with comprehensive training and tools	Determine and implement appropriate inventory levels for revenue officers	Promote an environment which optimizes employees' talents and encourages employee involvement		
		Assess effectiveness of current training delivery methods and establish clear direction for future training		Identify and implement balanced reward and recognition programs to motivate BSA employees		Implement steps to increase annual employee satisfaction survey participation rates, and ensure that all elevated issues are addressed at the appropriate level of management		
		Ensure availability of timely and accurate training materials		Implement quality review and establish a case quality baseline				
		Develop course material to address deficiencies		Assemble, review, and incorporate feedback from the field to update the Reengineering Lead sheets				
		Improve delivery of leadership and managerial training		Develop and align BSA Program strategies to achieve organization goals and objectives				
		Partner with Learning & Education and W&I Exam HQ in developing a standardized Three-Level Correspondence Examiner Training Curriculum for consistency of issue skill level among all ten campuses		Create and sustain a positive workplace environment and support continuous learning for both BSA Policy and Field Operations employees				
		Provide employees with opportunities to build, and learn how to better utilize, the tools and resources available to them		Engage all employees in achieving objectives and priorities to promote employee satisfaction				
		Address employee engagement as the key to improvement of employee engagement		Solicit employee feedback and establish a process to elevate issues through open and honest communication between employees and management				
		Focus on opportunities to impact employee engagement through reengineering efforts, improved tools, enhanced and more focused training and increasing communication on a regular basis		Provide direction and support to overcome employee performance barriers				
		Identify barriers that may prevent employees from accurately and timely performing their required duties (as part of follow-up to PDM training)		Recognize employees for contribution to the Fraud program beyond the scope of the job duties				
		Increase employee engagement by emphasizing the communication of expectations and guidelines, early managerial involvement in case work, and ongoing dialogue to ensure messages are received and correctly applied						
		Issue timely and accurate technical guidance						
		Continue to solicit employee recommendations for program improvements and enhancements						
		Maintain open lines of communication with the campus operations						

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	OCLL	CLD	TBR	EEO & Diversity
Enhance Data Security and Protect Sensitive Information	Ensure that all employees are in full compliance with all IRS equipment and data security requirements. It is critically important that any sensitive files be immediately put into an encrypted state when not in use.							
	All taxpayer information, private information, names with associated social security numbers, employee evaluations, procurement documents and anything else that fits a broad category of "sensitive" must be removed or properly encrypted							
	Managers must verify that every employee understands how to use the IRS encryption software							
	Managers must verify that every employee review all data on their laptop or other portable media storage devices, and if sensitive information is not specifically needed in the performance of duties, then that sensitive information must be removed							
	Managers must verify that every employee understands his or her responsibility to properly protect all sensitive information on a laptop or other portable media storage devices including protection of IRS IT equipment while out of the office in a travel status. Laptops are never to be checked in with luggage on a commercial flight or left unattended at							
	SB/SE has set up a special computer data security web site that provides information and guidance to assist employees in complying with all IRS data security requirements.							
	SB/SE's Business Systems Planning (BSP) organization will be available to answer all questions regarding data security requirements.							
Expand Embedded Quality	Focus on increasing the emphasis on building quality into day-to-day compliance activities	Evaluate Quality Improvement Infrastructure development (Quality improvers) in recommending continuance of the program	Implement a National Quality Review Staff for Specialty to identify quality concerns as early in the examination process as possible and work to initiate resolutions to any deficiencies					
	Measure Quality at the front-line where timely improvements to processes can be instituted	Ensure consistency of reviews – Maintain EQ systems database for validation and trend analysis	Pilot Embedded Quality for Examination and Collection and rollout to front-line managers in all compliance programs					
	Fully implement and effectively use of the Embedded Quality concept	Rollout Embedded Quality for Liens in FY 2006						
		Expand Embedded Quality into the Centralized Insolvency Operation						
Maintain a consistent and coordinated approach to a burden reduction program that meets customer needs						Partner with the Office of Taxpayer Burden Reduction (OTBR) to develop key messages and products related to approved stakeholder or taxpayer burden issues	Simplify Tax Forms, Publications and Notices	
						Work with OTBR to develop a strategy to deliver products and key messages through SL liaison activities	Streamline Internal Policies, Processes and Procedures	
						Ensure effective and timely communications with key stakeholder groups	Promote Less Burdensome Rulings	
						Ensure that CLD functions have the staffing, training and tools to support the taxpayer burden reduction initiatives, and will monitor the effectiveness of the CLD support	Develop a More Accurate and Reliable Burden Measurement Methodology and Model	
							Partner with Internal and External Stakeholders to More Effectively and Efficiently Identify and Address Burden Reduction Initiatives	

Priority	Actions by program area							
	EXAM	COMP SVC	SPECIALTY	Fraud/BSA	COLL	CLD	TBR	EEO & Diversity
Ensure Accomplishment of the SB/SE EEOC 715 Plan								Strengthen OU involvement in the development and delivery of the MD-715 action items
								Develop a strategic, multi-year Federal Agency Annual EEO Program Status Report (MD-715) to allow for more measurable results through effective identification of root causes along with a more extensive barrier analysis and elimination process
								Identify significant trends, issues and problems and provide advice and guidance during settlement negotiations, the reasonable accommodation process, and other program areas
								Perfect and provide data analysis and support to each OU for Operational Reviews including costs and other requirements associated with the No Fear Act
								Ensure that EEO complaints are properly aligned in their data systems based on the new SB/SE organizational structure
								Provide data analysis to the field level, and ensure early identification of the proper management officials for participation during ADR or formal settlement discussions
								Work with SB/SE managers to resolve workplace issues that result in allegations of unlawful discrimination.
								Continue to promote ADR/mediation at the informal and formal stage of the EEO complaint process. Develop measures to monitor improvement in this area
								Identify ways to evaluate hiring and promotion practices, policies and procedures
								Identify and remove barriers that impact on our manager's accountability for the reasonable accommodations process
								Ensure timely compliance with terms of settlement agreements, as well as with any EEOC/Court orders and directives

Addendum II
SB/SE Measures:

Enterprise

Budget Level

BPR Key Program Measures

Enterprise Measures	FY 2005 Actual Performance	FY 2006 Planned Performance	FY 2007 Planned Performance
Enterprise Collection Program			
Outcome Measures:			
Collection Coverage - Units [*†]	53%	52%	53%
Efficiency Measures:			
Collection Efficiency - Units [*†]	1514	1664	1718
Enterprise Examination Program			
Outcome Measures:			
Examination Coverage--Individuals	0.9%	0.9%	1.0%
Efficiency Measures:			
Exam Efficiency--Individuals	122	122	130
Enterprise Automated Underreporter			
Outcome Measures:			
AUR Coverage	2.2%	2.3%	2.4%
AUR Efficiency	1701	1759	1828

[*†] The variation in performance between FY 2005 actuals and FY 2006-2007 targets for these measures represents a change in definition and methodology effective in FY 2006

Source: FY 2008 Oversight Board Budget Submission – June 2006

Budget Level Measures	FY 2005 Actual Performance	FY 2006 Planned Performance	FY 2007 Planned Performance
PAC 7C--Automated Collection System (ACS)			
Outcome Measures:			
Customer Accuracy--ACS Phones	88.5%	89.7%	90.3%
PAC 7D--Field Collection			
Outcome Measures:			
Collection Field Embedded Quality (EQ)	N/A	†Baseline	†TBD
PAC 7G--Field Examination			
Outcome Measures:			
Field Exam Embedded Quality (EQ)	N/A	†Baseline	†TBD
Office Exam Embedded Quality (EQ)	N/A	†Baseline	†TBD

† Results pending outcome of negotiations with NTEU

Source: FY 2008 Oversight Board Budget Submission – June 2006

BPR Key Program Measures	FY 2005 Actual Performance	FY 2006 Planned Performance
Field Exam - 7G (Includes general program results from Specialty- International Program)		
*EMPLOYEE SATIFACTION: Field Exam ES Survey	70%	67%
**CUSTOMER SATISFACTION: % Satisfied	57%	62%
**CUSTOMER SATISFACTION: % Dissatisfied	26%	22%
US - Revenue Agents (RA)		
FTE	6,999.80	7,177
CLOSURES: Closures IMF < $100K	50,460	51,490
CLOSURES: Closures IMF ≥ $100K	52,572	65,333
CLOSURES: Closures SB Corp	13,659	13,092
CLOSURES: Closures SB Flow Thru	16,820	17,096
CLOSURES: Total Closures per FTE	19	20
TIMELINESS: Closed Cycle Time IMF	258	258
TIMELINESS: Closed Cycle Time SB Corp	235	235
TIMELINESS: Closed Cycle Time ISB Flow Thru	239	239
QUALITY: Field Exam Quality Score (Interim)	86.2%	86.5%
US - Tax Compliance Officers (TCO)		
FTE	1,449.50	1,505
CLOSURES: Closures IMF < $100K	112,213	108,783
CLOSURES: Closures IMF ≥ $100K	28,567	27,109
CLOSURES: Closures per FTE	97	91
TIMELINESS: Closed Cycle Time IMF	194	194
QUALITY: Office Exam Quality Score	85.3%	85.5%

Source: Unless otherwise noted below, SB/SE Business Performance Review (BPR) – April 2006 is the source for all actual and planned performance

* Employee Satisfaction: FY 2005 Actual Employee Satisfaction scores per Gallup and FY 2006 Planned Employee Satisfaction goals set in the Revised Employee Satisfaction Performance Goals memorandum dated August 4, 2004 issued by the Director, SB/SE SPRM

** Customer Satisfaction: FY 2005 actuals and FY 2006 YTD performance per PCG Customer Surveys results issued August 2005 and June 2006, respectively

BPR Key Program Measures	FY 2005 Actual Performance	FY 2006 Planned Performance
Specialty Taxes - 7N		
US - Employment Tax (Employment Tax Programs include results from Field Exam)		
FTE	253	337
CLOSURES: Total Closures	30,843	32,272
US - Excise Tax (Excise Tax Programs include results from Field Exam)		
FTE	326	366
CLOSURES: Total Program Closures	16,557	16,200
US - Estate & Gift Tax		
FTE	647	509
CLOSURES: Total Closures	8,198	7,741

Source: Unless otherwise noted below, SB/SE Business Performance Review (BPR) – April 2006 is the source for all actual and planned performance

* Employee Satisfaction: FY 2005 Actual Employee Satisfaction scores per Gallup and FY 2006 Planned Employee Satisfaction goals set in the Revised Employee Satisfaction Performance Goals memorandum dated August 4, 2004 issued by the Director, SB/SE SPRM

** Customer Satisfaction: FY 2005 actuals and FY 2006 YTD performance per PCG Customer Surveys results issued August 2005 and June 2006, respectively

BPR Key Program Measures	FY 2005 Actual Performance	FY 2006 Planned Performance
BSA/Fraud (7J)		
FTE	326	452
CLOSURES: Title 31	3,712	6,427
CLOSURES: 8300	2,366	2,643
CLOSURES: Total Closures per FTE	19	20
Compliance Services		
EITC (7F)		
FTE	444.17	418.40
CLOSURES & EFFICIENCY: Audit Closures	145,706	145,779
CLOSURES & EFFICIENCY: Closures per FTE	395	420
TIMELINESS: Cycle Time – Closed Inventory	175	169
Discretionary Including HINF (aka Non-EITC) (7F)		
FTE	1,135.52	1,141.38
CLOSURES & EFFICIENCY: Audit Closures (1)	298,710	301,387
CLOSURES & EFFICIENCY: Closures per FTE	300	308
TIMELINESS: Cycle Time – Closed Inventory	177	169
Discretionary & EITC (7F)		
*EMPLOYEE SATIFACTION: Correspondence Exam ES Survey	63%	66%
**CUSTOMER SATISFACTION: % Satisfied	52%	52%
**CUSTOMER SATISFACTION: % Dissatisfied	27%	27%
QUALITY: Paper Accuracy	89.92%	93.00%
QUALITY: Paper Timeliness	94.62%	95.00%

(1) Non-EITC Audit Closures: Includes both BMF and IMF closures

Source: Unless otherwise noted below, SB/SE Business Performance Review (BPR) – April 2006 is the source for all actual and planned performance

* Employee Satisfaction: FY 2005 Actual Employee Satisfaction scores per Gallup and FY 2006 Planned Employee Satisfaction goals set in the Revised Employee Satisfaction Performance Goals memorandum dated August 4, 2004 issued by the Director, SB/SE SPRM

** Customer Satisfaction: FY 2005 actuals and FY 2006 YTD performance per PCG Customer Surveys results issued August 2005 and June 2006, respectively

BPR Key Program Measures	FY 2005 Actual Performance	FY 2006 Planned Performance
AUR (7E)		
FTE	816.45	844.80
CLOSURES & EFFICIENCY: Closures	1,848,702	2,004,585
CLOSURES & EFFICIENCY: Closures per FTE	2,264	2,373
*EMPLOYEE SATIFACTION: AUR ES Survey	59%	72%
**CUSTOMER SATISFACTION: % Satisfied	57%	57%
**CUSTOMER SATISFACTION: % Dissatisfied	16%	16%
QUALITY: Paper Accuracy	93.93%	97.00%
QUALITY: Paper Timeliness	96.54%	99.00%
CSCO (7B)		
CSCO FTE	1,258.70	913.06
ASFR FTE	201	180.53
6020 b closures	85,719	165,652
ASFR closures	425,624	497,012
*EMPLOYEE SATIFACTION: CSCO ES Survey	64%	69%
**CUSTOMER SATISFACTION: % Satisfied	56%	54%
**CUSTOMER SATISFACTION: % Dissatisfied	20%	22%
QUALITY: Customer Accuracy *(Collection Paper)*	90.38%	91.0%
QUALITY: Timeliness	93.22%	94.1%
ASFR QUALITY: Customer Accuracy *(ASFR Paper)*	86.75%	92.0%
ASFR QUALITY: Timeliness	78.79%	83.0%
ACS & Support (7C)		
Call Site FTE	1,254.20	1,331.80
Support Site FTE	323.40	309.20
CLOSURES & PRODUCTIVITY: Closures – TDA	672,420	713,003
CLOSURES & PRODUCTIVITY: Closures – TDI	185,094	218,242
CLOSURES & PRODUCTIVITY: TDA Productivity	536	535
CLOSURES & PRODUCTIVITY: TDI Productivity	148	164
*EMPLOYEE SATIFACTION: ACS Survey Call Site	51%	64%
**CUSTOMER SATISFACTION: % Satisfied Call Site	91%	91%
**CUSTOMER SATISFACTION:% Dissatisfied Call Site	3%	3%
ACS PHONES QUALITY: Customer Accuracy	87.20%	88.30%
ACS PHONES QUALITY: Timeliness	96.30%	96.10%

Source: Unless otherwise noted below, SB/SE Business Performance Review (BPR) – April 2006 is the source for all actual and planned performance

* Employee Satisfaction: FY 2005 Actual Employee Satisfaction scores per Gallup and FY 2006 Planned Employee Satisfaction goals set in the Revised Employee Satisfaction Performance Goals memorandum dated August 4, 2004 issued by the Director, SB/SE SPRM

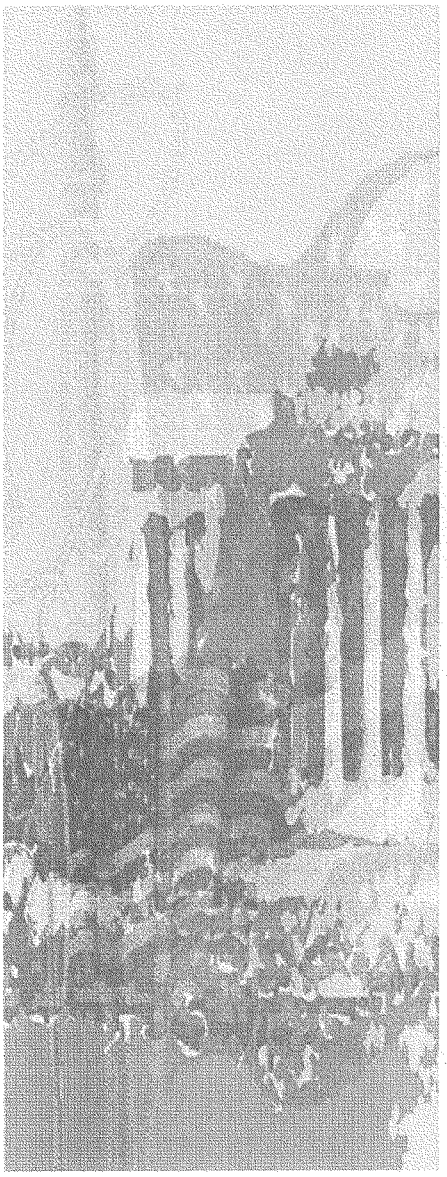
** Customer Satisfaction: FY 2005 actuals and FY 2006 YTD performance per PCG Customer Surveys results issued August 2005 and June 2006, respectively

BPR Key Program Measures	FY 2005 Actual Performance	FY 2006 Planned Performance
COIC (7B)		
FTE	578.50	503.11
DISPOSITIONS: Total Dispositions	54,951	57,293
DISPOSAL TIME: Number of Cases Disposed in 6 – 12 Months	4%	5%
QUALITY: Customer Accuracy	96.13%	96.13%
QUALITY: Timeliness	96.79%	96.79%
Field Collection (7D & 7P)		
FTE	7,239.33	7,144
TDA PROGRAM: TDA Closures – modules	1,056,455	1,079,000
TDA PROGRAM: TDA Modules per IFS FTE – Total FAC 7D plus FAC 7P	146	153
TDA PROGRAM: Percent Overage – TDA/TDI Taxpayers Combined	9%	7%
TDI PROGRAM: TDI Closures – total investigations	198,275	208,000
TDI PROGRAM: TDI Total Investigations per IFS FTE – Total FAC 7D plus FAC 7P	27	30
OIC PROGRAM: OIC Field Closures	36,392	26,640
EMPLOYEE SATIFACTION: (Q17 Percent Satisfied)	63%	63%
**CUSTOMER SATISFACTION: % Satisfied	63%	62%
**CUSTOMER SATISFACTION: % Dissatisfied	19%	21%
FIELD COLLECTION EQ INTERIM SCORE	73%	75%
Communications, Liaison & Disclosure (5C)		
FTE *(source: IFS)*	816	648
Timeliness of FOIA/PA responses *(Added due to the recent Whitehouse Executive Order pertaining to FOIA timeliness. No target has been set or reflected in the BPR)*	82%	---

Source: Unless otherwise noted below, SB/SE Business Performance Review (BPR) – April 2006 is the source for all actual and planned performance

* Employee Satisfaction: FY 2005 Actual Employee Satisfaction scores per Gallup and FY 2006 Planned Employee Satisfaction goals set in the Revised Employee Satisfaction Performance Goals memorandum dated August 4, 2004 issued by the Director, SB/SE SPRM

** Customer Satisfaction: FY 2005 actuals and FY 2006 YTD performance per PCG Customer Surveys results issued August 2005 and June 2006, respectively



MITS
Strategic Plan

FY 2005-2006

January 27, 2005

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Introduction

The Modernization and Information Technology Services (MITS) organization supports the IRS' three strategic goals: (1) improve taxpayer service; (2) enhance enforcement of the tax law; and, (3) modernize the IRS through its people, processes and technology.

MITS' accomplishes this through our strategic goals of:

- Improving Service
- Delivering Modernization
- Increasing Value

The attached MITS Strategic Plan provides a roadmap for MITS organization's priorities and strategic initiatives for this fiscal year. Our successes in 2005 will be built upon our success in 2004. Everyone in MITS should be proud of our accomplishments in 2004 which included:

Modernization

In 2004, we had the most successful year ever for the IRS Business Systems Modernization (BSM) program. Our success in 2004 can be measured by the number of projects we delivered the schedule and cost targets we hit, and the substantial improvements we made in program management.

We delivered the first release of the Customer Account Data Engine (CADE) project, and for the first time in 40 years the IRS started processing an initial set of the simplest tax returns on a new computer system. We launched our new Integrated Financial System (IFS), and declared it the IRS' financial accounting system of record. We deployed a full suite of e-Services products, which provide tax professionals and the businesses with new Web-based tools that dramatically improve their interface with the IRS. Additionally, we released Modernized e-File, whereby corporations and tax-exempt organizations can file their annual income tax and information returns electronically.

We have also made significant improvements in our cost estimating and scheduling. In the Fall/Winter of 2003 (during the annual program planning process), we re-base lined the cost estimates and delivery schedules for each of the BSM program projects. Since then, both our cost and scheduling performance have dramatically improved. With the exception of one (the Integrated Financial System) all projects were delivered on time (either early or within a few weeks of schedule) and within budget. This is a major accomplishment. It demonstrates that the steps we took in 2004 to improve program performance are having a positive impact. Thus, due to the successful implementation of numerous program management improvements, 2004 did not follow the pattern of cost overruns that had occurred from 1999 through 2003. We also showed a marked improvement in significantly reducing our variances between cost estimates and actual delivery costs from 33 percent in 2002 to 4 percent in 2004.

Workforce Realignment: Recognizing that MITS could not implement its complex workforce restructuring initiatives without a comprehensive and aggressive strategy to minimize the adverse impact on employees, we successfully negotiated a ground breaking mitigation strategies agreement with NTEU. During the past year restructuring activities included implementation of the EUES Campus Operations Most Efficient Organization (MEO), the Enterprise Operations Competency Based Organization (CBO), and the realignment of Enterprise Operations staffing within the MITS Blueprint.

Leadership and Employee Engagement: We asked for your participation in the last years Employee Engagement Survey, and you responded with a record 85%. We are conducting workgroup meetings throughout the country and solving problems which enable our workforce resolve workplace issues and work in a more productive environment.

We have continued to make progress in filling key position in the MITS Senior Leadership team through the selection of outstanding executives from both government and corporate America. This year, the ACIO BSM, Deputy ACIO ITS, and the ACIO Management were selected to provide leadership and direction as we face the challenges ahead.

For the current Fiscal Year, the Chief Information Office has modified his priorities to include continued emphasis on modernization and workforce realignment, and have added emphasis on vision/strategy/portfolio/Conops and Security.

Deliver Modernization: Emphasis will remain on maintaining the successful track record of on-schedule, on-budget release upgrades for the major modernization applications, to include CADE, Modernized e-File, e-Services, and IFS. 2005 will see the start of a major new application, Filing & Payment Compliance (F&PC). Eventually meant to replace all of the IRS' legacy systems that support collections processing, the initial releases of F&PC will focus on supporting the IRS' use of Private Collection Agencies (PCAs). The initial release of F&PC is slated for production use in January, 2006.

In addition to the focus on release delivery, modernization efforts are underway to develop the processes and select the tools for the IRS to capture the requirements and business rules necessary for long-term tax administration modernization. With the continued retirement of employees steeped in understanding the legacy systems environment, it is imperative that we capture their knowledge in a modernized requirements repository that can serve as the basis for the requirements baseline for new systems development.

Emphasis is also being placed on resetting the modernization strategy for the IRS. Given a more constrained budget environment, and the overwhelming impact of the Internet on business models, we are revamping goal state and transition plans. As part of this effort, the IRS is looking to better coordinate all of its IT modernization investments, whether it

is enterprise-level new applications, departmental systems, or upgrades to existing legacy systems.

Workforce Restructuring: Continued emphasis on mitigating the impact of RIF on employees will be our top priority. We must also successfully implement each reorganization so that programs are delivered effectively and customer needs are served. Successful implementation of our new organizational structures will require completion of and implementation of all design work so that employees are trained and stable work processes are in place.

Vision and Strategy: Your survey feedback indicated that we need extensive focus on MITS vision, strategy, portfolio, and management. Only 4 in 10 respondents strongly agreed that they know what is expected of them at work. Scores also reflected a low linkage between employees and the MITS mission/strategy. To address these issues, we have implemented meetings between each manager and employee in MITS to discuss the MITS strategic plan. We will also develop our MITS vision and mission statement by engaging employees and managers across the country in focus groups that are currently underway. Other initiatives that we will be pursuing to strengthen the connection between MITS employees and our vision and strategy include development of a comprehensive performance measurement system and design of a Concept of Operations that will guide future strategic planning and modernization investment efforts. We will continue to solicit input from all levels of MITS about our strategic planning process through focus group interviews.

IT Security: We will approach security as an enterprise wide challenge and ensure we have identified the costs and needs for a secure IT environment in IRS. We must embed security into the fabric of MITS from Concept to Maintenance, and work with Mission Assurance to ensure compliance with legislation and standards and quantify the resource costs.

As you can see these broad priorities will require not only the commitment of the MITS leadership team but the entire MITS workforce. Our Strategic Plan, which is explained further in this document, is essential to ensure that our strategic goals are fully resourced, incorporated into operational plans, and delegated to responsible parties. Your will see how the areas of emphasis highlighted above, plus other areas of strategic emphasis have been incorporated in the MITS Strategic Plan. We urge each of you to read the following plan and discuss it with your supervisor and raise any questions that you have.

FY2005 STRATEGIC PLANNING PROCESS

The MITS' Strategic Planning Process begins with an assessment of each Strategic Goal. This assessment process is conducted for the purpose of comparing where we are today with where we want to be in the future. The goals we have identified are stable from year to year and reflect the long range outcomes that we focus our resources on. These goals are expressed as follows:

- Improve service to our customers,
- Deliver modernized systems and infrastructure, and
- Increase the value of MITS resources.

The gaps that we identify between our desired future state and where we are today form the basis for the specific strategies that comprise our Plan. Each of the specific strategies within the Plan is designated as an Operational Priority. The alignment of Operational Priorities with our Strategic Goals is as follows:

Strategic Goal	Operational Priority
1. Improve service to our customers	• Enable IRS business outcomes and improve service to MITS' customers
2. Deliver modernized systems and infrastructure	• Accelerate MITS Modernization to Maximize Modernization Potential, Promote Operational Efficiencies, and Strengthen Transition of BSM Systems into the Operating Environment • Ensure the Security of All IT Systems and Processes
3. Increase the value of MITS resources	• Position MITS Human Capital to Enhance Employee Productivity and Ensure the Availability of Vital Skills • Increase Operations Efficiency and Effectiveness

The next step in the Strategic Planning Process is to drill down within each Operational Priority and identify the specific Improvement Projects that are necessary to achieve progress in the upcoming fiscal year.

The following provides both a high level summary of the assessment of each Strategic Goal and alignment which has resulted in the identification of each Operational Priority and Improvement Project.

Please note that during Fiscal Year 2005, MITS will be developing a more integrated Strategic Planning process that will ensure increased employee involvement in Strategic Planning. By working as a team to identify MITS strategic direction and formulate Improvement Projects and action plans, we will be able to improve on our ability to improve IT support and services to our customers, deliver modernized systems and infrastructure, and increase the value of MITS resources.

Strategic Goal 1 - Improve Service to Our Customers

Assessment: MITS needs to take actions to provide seamless, well coordinated IT service and support to Business Units that meets or exceeds customer Master Service Level Agreements. The challenges that MITS' faces in delivering on these goals include the following:

- Addressing continuing budget shortfalls, including FY '05 needs in excess of $70 million. Due to fact that MITS' has been required to absorb cost of living increases and various rescissions over the past three years, the actual spending power of the MITS Budget has decreased by $145M.
- Maintaining the customer satisfaction levels experienced during the past year. The MITS' internal customer satisfaction ratings have increased from 69.8 to 80.1.
- Maintaining Employee Satisfaction Survey participation rates and increasing MITS' overall satisfaction ratings. Employees identified understanding of and commitment to MITS vision, mission, and strategy as key improvement areas.

In recognition of these challenges, the following Operational Priorities and Improvement Projects will be accomplished to support Strategic Goal 1.

STRATEGIC GOAL 1: Improve Service to Our Customers	
Operational Priorities	**Improvement Projects**
Enable IRS Business Outcomes and Improve Service to MITS Customer	Expand self service capabilities to other users and critical systems
	Develop a comprehensive printer strategy
	Implement Enterprise Internet Protocol Telecommunications Systems
	Integrate MITS strategic planning process within and outside MITS and align with IRS Strategic Plan
	Workforce Realignment
	Meet or exceed our customer agreements (MSLA) and perform quarterly performance reviews
	Develop an internal and external communications strategy and plan
	Develop and implement processes to use results of employee survey to improve employee engagement
	Replace VPN and SDI with Enterprise Remote Access Capability (ERAP)
	Implement TRIPLEX recommendations as needed
	Provide one-stop customer service

Strategic Goal 2 – Deliver Modernized Systems and Infrastructure

Assessment: MITS must effectively manage modernization schedules and costs, and deliver functionality needed by the Business and Operating Units, and Taxpayers; while simultaneously providing a bridge between modernization and production systems. To achieve these goals, MITS' modernization Operational Priorities focus on resolving the following challenges:

- Reprioritizing and rescaling BSM modernization projects in order to accommodate budget reductions in FY '05 and '06.
- Minimizing or eliminating cost overruns and schedule slippage in Modernization projects
- Improving transition to modernization planning and implementing budget adjustments for transition resource shortfalls.
- Upgrading infrastructure to support new applications and modernized systems
- Designing and implementing an integrated Capital Planning and Investment Control process and schedule.
- Increasing regulatory requirements and costs for IT Security

The following Operational Priorities and Improvement Projects comprise the scope of MITS' modernization initiatives.

STRATEGIC GOAL 2: Deliver Modernized Systems and Infrastructure	
Operational Priorities	**Improvement Projects**
Accelerate MITS Modernization to Maximize Modernization Potential and Promote Operational Efficiencies and Strengthen Transition of BSM Systems into the Operating Environment	Develop MITS concept of operations (CONOPS)
	Develop approach to business rules harvesting and rules engine utilization, and acquire tools to implement selected approaches
	Develop the procedures to implement the tools effectively operate and monitor modernized systems in a production environment
	Develop/implement 05/06 BSM releases
	Accelerate/prioritize those modernization initiatives (i.e., Mod-efile, E-Services and CADE) that have the potential to retire legacy systems and increase operational efficiencies
	Develop, document, and implement CPIC
	Improve MITS processes
	Improve contractor performance on cost, schedule, scope, quality and productivity
	Strengthen contracting practices with increased use of firm-fixed price task orders and other performance-base contract models
	Establish and implement ongoing third party reviews
	Implement Transition Management Repository (TMR) MITS-wide

STRATEGIC GOAL 2: Deliver Modernized Systems and Infrastructure	
Operational Priorities	**Improvement Projects**
	Establish and implement ITS Project Services Office to support effective modernization coordination, implementation, and transition management between BSM and ITS
	Build a model for use by BSD as a co-developer for Tier A modernized systems
Ensure the Security of All IT Systems and Processes	Implement Disaster Recovery (DR) infrastructure for Tier A Modernization applications and core services
	Implement encryption with transmitters to ensure taxpayer data is secure
	Implement information security roles and responsibilities
	Build and implement ITS business resumption strategy

Strategic Goal 3 – Increase the Value of MITS Resources

Assessment: MITS must focus on efforts to maximize the value of both MITS' human and capital resources in support of business priorities. MITS' inability to accurately attribute cost to products and services, to benchmark against IT best practices, to plan adequately for the workforce competencies necessary to deliver modernized systems, to efficiently measure MITS' performance against internal and external customer expectations, and to align its workforce to maximize performance continue to remain our key challenges. In addition, MITS must identify and deliver efficiencies in the current operating environment in order to meet increasing business units' needs in a contracting budget environment.

The following Operational Priorities and Improvement Projects will be accomplished to support Strategic Goal 3.

STRATEGIC GOAL 3: Increase the Value of MITS Resources	
Operational Priorities	**Improvement Projects**
Position MITS Human Capital to Enhance Employee Productivity and Ensure the Availability of Vital Skills	Strengthen EEO/Diversity Program
	Ensure skills are available to support MITS operations
	Develop organizational changes, practices, and process improvements resulting from the MITS sourcing strategy
Increase Operations Efficiency and Effectiveness	Modernize and refresh infrastructure
	Establish and conduct ongoing benchmarking
	Establish a business plan and goals to increase operational efficiencies and retire legacy systems
	Implement MITS cost accounting
	Develop and implement performance metrics to more effectively measure MITS performance

GOALS MAP

MITS Support to Treasury and IRS Goals and IRS/Business Units' Objectives

The tables below display the relationship between MITS' Strategies and Operational Priorities to the IRS and Treasury Strategic Goals, and IRS and Business Unit Objectives.

Treasury Strategic Goal: Manage the Government's Finances Effectively (Objective F41)		
IRS Strategic Goal 1: Improve Taxpayer Service		
MITS Strategic Goal 1: Improve Service to Our Customer		
IRS Strategic Objectives	***BU Operational/Program Priorities***	***MITS Operational Priorities & Related IT Projects***
Improve Service Options for the Tax Paying Public Facilitate Participation in the Tax System by All Sectors of the Public Simplify the Tax Process	**W&I** Align training, processes and automated tools (accounts) for Customer Service Representatives (CSRS) to enhance efficiency and customer satisfaction. Expand Options for Electronic Filing, Paying, Communication Services and Other Automated Services. **Appeals** Improve Efforts to Forecast Projected Receipts Implement Appeals Presence in the Campuses **SB/SE** Improve Service to SB/SE Customers Ensure Interacting with the IRS Electronically Becomes the Preferred Option Reduce Burden on Small Business Taxpayers	**OP**: Enable IRS Business Outcomes and Improve Service to MITS Customer **Projects** • Correspondence Imaging System (CIS) • Queuing Management Systems • Integrated Customer Communications Environment (ICCE) • Telefile • EFTPS • IRP • IMF/BMF • CADE • Tax Return Database • Electronic Funds Transfer • Electronic Management System • LMSB Decision Support & Analytics • LMSB Data Mart • Examination Returns Control Systems • Taxpayer Public Information Directory (QPID) • Business Filers Module/Electronic Filing • E-Services • IDRS • Enrolled Practitioners Systems (EPS) • Federal Tax Deposits (FTD) • Taxpayer Advocate Service Management/Control System (TAMIS) • Contact Recording

Treasury Strategic Goal: Manage the Government's Finances Effectively (Objective F41)		
IRS Strategic Goal 1: Improve Taxpayer Service		
MITS Strategic Goal 1: Improve Service to Our Customer		
IRS Strategic Objectives	***BU Operational/Program Priorities***	***MITS Operational Priorities & Related IT Projects***
	TAS Increase the scope and accessibility of services offered electronically	

Treasury Strategic Goals: Manage the Government's Finances Effectively (Objective F41) Preserve the Integrity of Financial Systems (Objective F3A)		
IRS Strategic Goal 2: Enhance Enforcement of Tax Law		
MITS Strategic Goal 1: Improve Service to Our Customers		
IRS Strategic Objectives	***BU Operational/Program Priorities***	***MITS Operational Priorities & Related IT Projects***
Discourage and Deter Non-Compliance with Emphasis on Corrosive Activity by Corporations, High-Income Individual Taxpayers and Other Contributors to the Tax Gap Detect and Deter Domestic and Off-shore Based Tax and Financial Criminal Activity	**W&I** Enable case resolution through a comprehensive view of the taxpayer's account. Provide self assist and/or self-correct interactions to enable taxpayers to resolve compliance issues Improve workload and workforce management to optimize resource allocation and dynamically balance the workload. Identify and implement enhancements to remote Exam systems (including CEAS, RGS, and RGS Batch) to enable systemic risk-based scoring, classification, issue identification and initial taxpayer contact	**OP:** Enable IRS Business Outcomes and Improve Service to MITS Customer **Projects** • Appeals Automated Environment (AAE) • Integrated Collection System (ICS) • Electronic Fraud Detection System (EFDS) • Counsel Automated Systems Environment (CASE) • Filing and Payment Compliance (F&PC) • Automated Underreporter (AUR) • Inventory Delivery System (IDS) • Audit Information Management System (AIMS) • Enforcement Revenue Information System (ERIS) • RGS • Excise Files Information Retrieval System (EXFIRS)

Treasury Strategic Goals: Manage the Government's Finances Effectively (Objective F41) Preserve the Integrity of Financial Systems (Objective F3A)		
IRS Strategic Goal 2: Enhance Enforcement of Tax Law		
MITS Strategic Goal 1: Improve Service to Our Customers		
IRS Strategic Objectives	***BU Operational/Program Priorities***	***MITS Operational Priorities & Related IT Projects***
Deter abuse within Tax-Exempt and Governmental Entities by third parties for tax avoidance or other unintended purposes	**LMSB** Implement technology including the LMSB Information Management System; the Issue-based Management Information System, Modernized E-File, and the Return Scanning and data capture process. **SB/SE** Increase Compliance Among SB/SE Taxpayers Ensure interacting with the IRS electronically becomes the preferred option for SB/SE customers Improve business results by enhancing our operational practices and processes **TEGE** Deter abuse within tax-exempt and governmental entities by third parties for tax avoidance or other unintended purposes	• TE/GE Reporting and Electronic Examination System (TREES) • Tax Exempt Determination System (TEDS) • Centralized Examination Classification (CECS) • Criminal Investigation Management Information System (CIMIS) • Remittance Transaction Research (RTR) • Corporate Files on Line (CFOL) • Compliance Questionable W-4 (CQW4) • Currency and Banking Retrieval System • Automated Substitute for Return (ASFR)

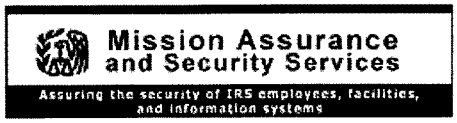
Treasury Strategic Goal: Manage the Government's Finances Effectively (Objective F41)		
IRS Strategic Goal 3: Modernize the IRS through Its People, Processes and Technology		
MITS Strategic Goal 2: Deliverer Modernized Systems and Infrastructure MITS Strategic Goal 3: Increase the Value of MITS Resources		
IRS Strategic Objectives	***BU Operational/Program Priorities***	***MITS Operational Priorities & Related IT Projects***
Increase Organizational Capacity to Enable Full Engagement and Maximum Productivity of Employees Modernize Information Systems to Improve Service and Enforcement Modernize Business Processes and Align the Infrastructure Support to Maximize Resources Devoted to Frontline Operations Ensure Safety and Security of People, Facilities and Information systems Modernize Business Processes and Align the Infrastructure Support to Maximize Resources Devoted to Frontline Operations	**LMSB** Leverage new technologies and tools, including imaging, electronic filing, Schedule M-3, and implementation of the Issue Management System to improve the timeliness and availability of data to identify compliance risks and refine return selection criteria in the LMSB population, to reduce the time required to deliver returns to the field, and to assist agents in issue development. **Appeals** Leverage technology to deliver process improvements and maximize efficiency **W&I** Identify less-costly methods of service delivery, such as automation, to reduce customer dependence on traditional methods of delivery, improve quality and utilize resources more efficiently Implement the CAS consolidation Use the organizational strategic goals identified in the W&I CONOPS to drive business changes and supporting technology in a sequence that positions the organization to incrementally reach the target state and optimizes our ability to achieve the desired business result.	**OP:** Position MITS Human Capital to Enhance Employee Productivity and Ensure the Availability of Vital Skills **OP:** Accelerate MITS Modernization to Maximize Modernization Potential and Promote Operational Efficiencies and Strengthen Transition of BSM Systems into the Operating Environment **OP:** Ensure the Security of All IT Systems and Processes **OP:** Increase MITS Operations Efficiency and Effectiveness **Projects** • Mod-efile • E-Services • CADE • Notice Modernization • Notice Redesign • IFS

Treasury Strategic Goal: Manage the Government's Finances Effectively (Objective F41)		
IRS Strategic Goal 3: Modernize the IRS through Its People, Processes and Technology		
MITS Strategic Goal 2: Deliverer Modernized Systems and Infrastructure MITS Strategic Goal 3: Increase the Value of MITS Resources		
IRS Strategic Objectives	***BU Operational/Program Priorities***	***MITS Operational Priorities & Related IT Projects***
	CI Information Technology Consolidation Criminal Investigation Management System Electronic Records Compliance Communities Accessing and Sharing Expertise (CASE) LynX **TE/GE** Exam Redesign Abusive Tax Avoidance Transaction (ATAT)	

MISSION ASSURANCE AND SECURITY SERVICES STRATEGY AND PROGRAM PLAN

FY 2007

MARCH 14, 2006



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I. STRATEGY PLAN

A. Overall Description

VISION

Critical IRS business processes and their supporting resources are protected

The Internal Revenue Service (IRS) plays a vital role in our national economic security, by providing a $2 trillion annual revenue stream to the United States Department of the Treasury that funds Federal government operations. The IRS must continue to implement this role in a new operating reality of increased threats, increased interdependence with customers and service providers, and overall increased complexity.

The vision establishes the direction of the Mission Assurance and Security Services (MA&SS) organization over the next three to five years. MA&SS supports the security and assurance of the overall IRS role in this new operating reality.

MISSION

Support the vital mission of the IRS by assuring the security and resilience of critical Agency functions and business processes

MA&SS is a service and support organization. Our role is to assist all IRS Operating Divisions, and peer service and support organizations, in maintaining secure facilities, technology, and data and also to ensure that IRS policies and programs adequately protect taxpayer and employee privacy.

Since 9/11 we have become increasingly aware that cooperation and integration are critical to creating a secure and sustainable environment. MA&SS provides the operational support to enable an integrated approach to physical, information technology, and personnel security. We do so by providing overall IRS mission assurance and security related leadership and promoting collaborative ownership and decision-making with all IRS organizations. Ensuring that a level of privacy that is worthy of taxpayer trust is maintained is a cooperative venture, requiring close and collaborative working relationships with business line organizations as well as organizations providing information technology and infrastructure capability. It is only through these partnerships that the innovation necessary to meet emerging privacy challenges can be adequately achieved.

B. Major Strategies and Operational Priorities

MA&SS activities enable all IRS operations and tax administration responsibilities by assuring the security of resources and resilience of national essential and critical agency functions. MA&SS has three major strategies, which demonstrate the desired outcome of MA&SS activities and define the outcomes that will enable the achie vement of the organizational vision.

STRATEGIES

1. IRS people, facilities, data and technology are secure and protected
2. Critical IRS business processes can continue operations through all emergencies and other disruptions
3. Mission Assurance and Security Services is providing efficient, value-added, customer-focused security solutions and support

The *IRS Strategic Plan: 2005 – 2009* guides the *Mission Assurance and Security Services Strategy and Program Plan*. The services and products provided by MA&SS are integral to enabling the IRS to achieve its mission. While MA&SS supports the overall IRS strategic plan, its strategies and operational priorities are directly associated with Goal 3 of the IRS strategic plan, as detailed in Table 1.

Table 1. Mission Assurance and Security Services Strategies Alignment with IRS Strategic Plan

Mission Assurance and Security Services Strategy	IRS Strategic Plan Linkage
Strategy 1 IRS people, facilities, data and technology are secure and protected	**Goal 3, Objectives 2 & 3** *Modernize information systems to improve service and enforcement* *Ensure the safety and security of people, facilities and information systems*
Strategy 2 Critical IRS business processes can continue operations through all emergencies and other disruptions	
Strategy 3 Mission Assurance and Security Services is providing efficient, value-added, customer-focused security solutions and support	**Goal 3, Objectives 1 & 4** *Increase organizational capacity to enable full engagement and maximum productivity of employees* *Modernize business processes and align the infrastructure support to maximize resources devoted to frontline operations*

The operational priorities describe the target level and characteristics of the service or products MA&SS intends to provide or facilitate to achieve the multi-year goals. Table 2 lists the three MA&SS strategies along with the operational priorities that support each of the strategies.

Table 2. Mission Assurance and Security Services Strategies and Operational Priorities

Strategy 1 IRS people, facilities, data, and technology are secure and protected	**Operational Priority 1**: Develop, implement and maintain a secure IT infrastructure
	Operational Priority 2: Identify and reduce IT security vulnerabilities
	Operational Priority 3: Develop, refine and update security policies and procedures
	Operational Priority 4: Ensure an appropriately balanced mix of security controls to adequately protect IRS assets, facilities and people
	Operational Priority 5: Conduct all employee and contractor employee investigations to meet or exceed security/suitability requirements and customer expectations
	Operational Priority 6: Ensure appropriate training and awareness programs are developed and available for all IRS employees and contractors
	Operational Priority 7: Embed privacy laws and regulations as a fundamental value that is ingrained into the IRS' taxpayer and employee policies and programs.
Strategy 2 Critical IRS business processes can continue operations through all emergencies and other disruptions	**Operational Priority 8**: Provide support to enterprise-level emergency management capabilities
	Operational Priority 9: Provide local emergency management support, including plan development and staff training
	Operational Priority 10: Support business units in building disaster recovery capabilities for IT systems
Strategy 3 Mission Assurance and Security Services is providing efficient, value-added, customer-focused security solutions and support	**Operational Priority 11**: Implement formal program, project and task management processes throughout MA&SS
	Operational Priority 12: Enhance employee engagement to proactively support MA&SS initiatives
	Operational Priority 13: Improve support functions and services to enhance the level and effectiveness of customer service
	Operational Priority 14: Provide MA&SS employees with development and training opportunities to enhance job satisfaction and performance
	Operational Priority 15: Develop a robust communication capability within MA&SS

Each operational priority is further defined by a set of results-oriented means and measures. The specific means and measures (Metrics) described in this document are defined in greater detail in the annual Program Plans prepared by the MA&SS organizations.

Strategy 1: IRS people, facilities, data and technology are secure and protected

In the IRS' increasingly complex security environment, MA&SS serves as a crucial line of defense against potential attacks to the integrity of IRS information, employees and critical infrastructure assets. As indicated in the *IRS Strategic Plan: 2005 – 2009*, we will "implement day-to-day security operations in a consistent and repeatable manner and protect the integrity of tax information." All of the MA&SS programs conduct vital initiatives in support of Strategy 1. In supporting this strategy, MA&SS is especially focused on developing an integrated approach resulting in an enterprise-wide plan of action.

Operational Priority 1: Develop, implement and maintain a secure IT infrastructure

Means

- Ensure managers can make sound risk-based operational decisions based on certification and accreditation strategies
- Ensure all IRS systems and applications are accredited in accordance with NIST guidance
- Develop a protocol for secure, electronic exchange of limited office use information
- Develop measures for audit processes
- Ensure that the IRS enterprise architecture adequately provides IT security mechanisms in alignment with the Federal Enterprise Architecture

Measures

- Higher percentage of accredited systems
- Maintain 100 percent accreditation for all modernized systems being implemented

Operational Priority 2: Identify and reduce IT security vulnerabilities

Means

- For projects in development, identify and mitigate weaknesses in the development cycle
- Use the FISMA POA&M as the primary tool to drive and track progress reducing IT security weaknesses
- Develop an approach for coordinating the requirements and implementation for security audit and analysis (SAAS)
- Maintain operational effectiveness of current cyber intrusion detection sensors (IDS) implementation, both host-based and network
- Expand install base of host-based intrusion detection
- Review the security audit and analysis system (SAAS) and other staff developed scripts to provide a channel for process and tool improvement to keep the IRS CSIRC on the leading edge of government network security operations
- Continue to develop the process for utilizing IT security specialists to conduct vulnerability scans to identify vulnerable systems
- Provide further training to IT security specialists responsible for performing FISMA scans
- Identify, test, acquire, and deploy tools to provide configuration and compliance management, vulnerability identification, vulnerability remediation/mitigation, as well as reporting capabilities

- Integrate correction of material weaknesses into the testing and validation process to ensure material weaknesses are either resolved and/or input into the POA&M for resolution
- Develop and maintain IDRS Security policies and procedures needed to address security in a changing environment
- Develop project management processes and procedures to track and report on FISMA-driven information security strategies and program plans

Measures

- Reduced number of TIGTA/GAO open findings
- Reduced number of cyber security notifications
- Reduced number of cyber incidents

Operational Priority 3: Develop, refine and update IT security policies and procedures

Means

- Develop an enterprise IT security policy, addressing information security policy gaps by reviewing and/or updating existing security policies, standards, guidelines and operational manuals for areas of concern, as well as drafting new policies, standards, guidelines, or manuals
- Develop and maintain IDRS security and policies and procedures needed to address security in a changing environment
- Develop new policies and strategies to provide a robust set of controls needed for systems and networks (e.g., policies at the application versus the platform level) and better align with NIST and FISMA guidance

Operational Priority 4: Ensure an appropriately balanced mix of physical security controls to adequately protect IRS assets, facilities and people

Means

- Complete a memorandum of understanding (MOU) with Real Estate and Facilities Management (REFM) concerning roles and responsibilities (especially in the area of fiscal responsibilities as the IRS moves closer to consolidation of facilities)
- Develop a risk assessment verification process
- Enhance or replace the automated risk assessment tool, after evaluating the existing tool. A preferred tool would be more quantitative and rely on weighted data to determine risk.
- Conduct lifecycle analysis of physical security systems for six campuses; identify gaps, and recommend strategies to address gaps/issues to mitigate threats and vulnerabilities.
- Upgrade security at all facilities to meet appropriate security levels, after completing standardized risk assessment reports for all facilities

Measures

- Reduced backlog of physical security upgrades
- Reduced physical security findings from GAO and TIGTA audits
- Reduced number of physical security incidents

Operational Priority 5: Conduct all employee and contractor employee investigations to meet or exceed security/suitability requirements and customer expectations

Means

- Issue program guidance and direction in accordance with Treasury, OMB and Department of Homeland Security (DHS) standards
- Provide the tools necessary to conduct investigations, including the facilitation of continued enhancements to Automated Background Investigation System (ABIS) to achieve additional efficiencies
- Hire staff to the level necessary to maintain acceptable investigative cycle times and product quality

Measures

- Number of investigations completed
- Cycle time of investigations

Operational Priority 6: Ensure appropriate training and awareness programs are developed and available for all IRS employees and contractors

Means

- Continuously improve existing formal training programs by incorporating the latest changes in policy and procedure
- Continue to seek new training programs applicable to MA&SS activities and areas of responsibility
- Continue to develop and conduct customer outreach visitations to educate internal and external customers on procedures and ways to streamline the investigative process
- Implement UNAX program to ensure proper treatment of sensitive information
- Develop awareness and training to educate the appropriate staff on incident management processes
- Provide tracking and notification to ensure effective training is accomplished
- Correlate specific training objectives with security roles and responsibilities

Operational Priority 7: Embed privacy laws and regulations as a fundamental value that is ingrained into the IRS' taxpayer and employee policies and programs.

Means

- Educate tax practitioners on privacy responsibilities and standards through presentations at key tax-related forums, round tables, and conferences
- Educate Federal and industry privacy and security practitioners on the Office of Privacy activities and goals through presentations at key industry conferences
- Develop and provide privacy general awareness training for all IRS employees and contractors; develop and provide job-specific training as appropriate.
- Monitor legislation with privacy implications and develop policy positions
- Conduct privacy impact assessments and privacy compliance reviews

Strategy 2: Critical IRS business processes can continue operations through all emergencies and other disruptions

Strategy 2 addresses the need to ensure the continuation of critical IRS business processes in the event of a disruption. This need is met by making business processes "resilient" through continuity planning and the development of emergency management, business continuity, and disaster recovery capabilities, as well as promoting the "resilient" design of the critical business processes (e.g., providing appropriate redundancy and avoiding single points of failure).

Operational Priority 8: Provide support to enterprise-level emergency management capabilities

Means

- Update, publish, and maintain an IRS (Headquarters) Continuity of Operations (COOP) Plan and related documentation
- Develop and implement a Headquarters COOP Test, Training, and Exercise (TT&E) program
- Develop and maintain Emergency Operations Center (EOC) policies, procedures, and guidelines for Headquarters and site Incident Commanders
- Develop and implement a TT&E program, including monthly testing of CSIRC and SAMC
- Develop and maintain Situation Awareness Management Center (SAMC) policies, standard operating procedures, and guidelines
-
- Monitor and track the development, maintenance, and TT&E of the suite of Business Continuity Plans (e.g., Incident Management Plan, Occupant Emergency Plan, Occupant Emergency Plan, Business Resumption Plan, and Disaster Plan)
- Provide subject matter expertise and coordination for internal and external oversight organizations, and other organizations in matters relating to Business Continuity/Critical Infrastructure Protection (CIP)

Measures

- All ELT, SAMT, and COOP Team members are trained and undergo regular refresher training
- ELT/SAMT, SAMC, and COOP documentation are regularly tested and exercised (and coordinated with stakeholders)

Operational Priority 9: Provide local emergency management support, including plan development and staff training

Means

- Direct and guide the IRS business operating divisions/functional operating divisions (BODs/FODs) as they identify and/or validate their business continuity planning information, single points of failure, and business resumption and mitigation strategies, and complete rollout of their Business Resumption Plans

- Support business units in the development, maintenance, and TT&E of the suite of Business Continuity Plans (Incident Management Plan, Occupant Emergency Plan, Business Resumption Plan, and Disaster Recovery Plan) to reflect current staffing, technologies, and business processes at all sites
- Support and observe the conduct of desk top and functional exercises of Business Continuity/Resumption Plans, Occupant Emergency Plans, and Incident Management Plans. Advise business units on improvements, and leverage lessons learned across the enterprise

Measures

- All business units have developed Business Resumption Strategies
- All responsible business units have developed Business Continuity/Resumption Plans for sites with critical business processes, Occupant Emergency Plans, and Incident Management Plans
- All business units have joined local Incident Management Teams where they perform a critical business process or provide an essential function
- All Business Continuity/Resumption Plans Occupant Emergency Plans, and Incident Management Plans are regularly tested and improvements incorporated

Operational Priority 10: Support business units in building disaster recovery capabilities for IT systems

Means

- Provide technical expertise to business units to clarify local questions concerning disaster recovery
- Participate in and facilitate discussions between MITS and the BODs/FODs on disaster recovery strategies and plans to ensure coordination of business recovery
- Consolidate the suite of Business Continuity Plans (Incident Management Plan, Occupant Emergency Plan, Business Resumption Plan, and Disaster Recovery Plan) into specific site plans or into plans covering the sites (such as territory or area level plans)
- Support business units in the development, maintenance, and test, training, and exercise (TT&E) of Disaster Recovery Plans to reflect current staffing, technologies, and business processes at all sites
- Work with system owners to ensure disaster recovery is addressed as part of the development cycle

Measures

- All business units have developed Disaster Recovery Strategies
- All IT system owners have developed IT Contingency Plans/Disaster Recovery Plans
- All IT Contingency Plans/Disaster Recovery Plans are regularly tested and improvements incorporated
- IT system owners regularly submit their IT Contingency Plans/Disaster Recovery Plans for review and audit

Strategy 3: Mission Assurance and Security Services is providing efficient, value-added, customer-focused security solutions and support

MA&SS is committed to the continuous improvement of its program management processes and capabilities. We will engage in an ongoing process of assessment and learning and will strive to communicate effectively with our customers. Our priorities include dedication to customer-service, enhanced employee engagement, enterprise-wide collaboration and providing growth and training opportunities for MA&SS staff.

Operational Priority 11: Implement formal program, project and task management processes throughout MA&SS

Means

- Design, develop, and conduct annual Program and Project Management Training for all program managers, and Program Office staff
- Develop annual program plans for each MA&SS office and corresponding organization.
- Design, develop, and integrate program planning processes with formal budgeting and reporting processes
- Review, analyze, and develop new budgeting processes so that budgets and expenditures can be tracked and reported upon by program office
- Routinely monitor progress in implementing Program Plans
- Use EMAP and other tools to exchange knowledge and lessons learned between employees
- Centrally track all guard force and physical security-related contracts and provide comprehensive, real-time analysis, reporting and oversight *(specific to Physical Security)*

Measures

- Program performance in implementing Program Plans is routinely monitored

Operational Priority 12: Enhance employee engagement to proactively support MA&SS initiatives

Means

- Use Survey 2004 activities (and Employee Engagement sessions) to identify improvement opportunities and create opportunities for employees to participate on project teams tasked with resolving identified issues
- Develop cross organizational teams (program and field) to find solutions to enterprise-wide problems
- Develop and implement "Recognition/Reward Programs" to elicit and recognize innovative ideas

Measures

- Increase in employee satisfaction scores in employee surveys

Operational Priority 13: Improve support functions and services to enhance the level and effectiveness of customer service

Means

- Continue to manage the Customer Support and Enterprise Risk Management Board (CSB)
- Continue to maintain and enhance MA&SS website to meet customer needs and reflect both organizational and program changes
- Manage the suggestions related to security for Employee Suggestion Program and respond to all suggestions in a timely manner. (also identify training and awareness needs based on said suggestions)
- Coordinate with appropriate IRS elements on office moves and office reconfigurations to ensure appropriate security is in place
- Conduct Customer Outreach briefings to elicit input from customers regarding needs and expectations
- Develop and implement new programs designed to capture, track, and resolve customer issues
- Establish cooperative, collaborative relationships to institutionalize structures and procedures to protect the IRS

Measures

- Increase in customer satisfaction, based on customer surveys

Operational Priority 14: Provide MA&SS employees with development and training opportunities to enhance job satisfaction and performance

Means

- Establish training coordinators in all MA&SS offices to design, develop, and/or administer applicable training programs
- Educate managers in the use of the Career Learning Plan process to help employees identify career goals and map developmental opportunities
- Develop succession plans and attractive career paths that align employee knowledge, skills and abilities (KSAs) with planned MA&SS activities/priorities; identify gaps and develop appropriate training programs

Measures

- Increased employee satisfaction as measured by employee surveys

Operational Priority 15: Develop a robust communication capability within MA&SS

Means

- Designate a central MA&SS point of contact to maintain MA&SS website, interfaces with Communications and Liaison and other enterprise-wide communications

- Establish a routine mechanism for two-way communications between Programs and field, as well as management and staff
- Establish internal communication roles and responsibilities
- Continue to maintain and enhance MA&SS website to identify and meet customer needs and reflect both organizational and program changes.

II. PROGRAM PLAN

MA&SS supports the vital mission of the IRS by assuring the security and resilience of critical Agency functions and business processes using risk-based decision-making practices. MA&SS is structured to enable an integrated approach to meeting security needs. There are six offices within MA&SS that shape the direction of services and initiatives. These offices are Information Technology Security; Emergency Management and Physical Security; Personnel Security and Investigations; Office of Privacy and Information Protection; Strategic Planning and Resources; and Audit Activity Management. Within these offices, there are organizations that perform the day-to-day activities fulfilling the MA&SS mission.

The MA&SS organization reports to the Deputy Commissioner Operations Support (DCOS) and is responsible for advising the DCOS and other IRS senior executives on issues related to mission assurance and security.

A. Information Technology (IT) Security

The IT Security Office addresses legislative requirements and improves enterprise-wide information security practices. The Information Technology (IT) Security Office is charged with identifying and mitigating threats, establishing policy and standards, determining strategy and priorities, and monitoring program implementation. In addition, the office provides customers with the tools, advice, security engineering, and tactical guidance necessary to ensure IT security. Specific areas of responsibility include management of the security program for the Integrated Data Retrieval System (IDRS), management of the System Audit Analysis System (SAAS), the IRS Internet Misuse and Monitoring Program, and incorporation of regulatory requirements such as the Federal Information Security Management Act (FISMA) and National Institute of Standards and Technology (NIST) guidance. The IT Security Office also serves as the focal point for incident response, disaster recovery coordination and monitoring of threat conditions IRS-wide. The IT Security Office is comprised of the following organizations: FISMA Program Office, IT Security Field Operations, Computer Systems Incident Response and Information Systems Disaster Recovery, and Technical Control Testing and Evaluation.

FISMA Program Office

Title III of the E-Government Act, entitled the Federal Information Security Management Act (FISMA), requires each Federal agency to develop, document, and implement an agency-wide information security program to provide information security for the information and information systems that support the operations and assets of the agency. The mission of the FISMA Program Office is to ensure compliance with FISMA legislation as well as with Office of Management and Budget (OMB), NIST, and Treasury regulatory requirements towards ensuring the confidentiality, integrity, and availability of IRS electronic resources, services, and data. The program office is charged with establishing IT security policy and standards, determining strategy and priorities, tracking compliance with FISMA requirements, monitoring program implementation, and establishing and coordinating enterprise-wide security training and awareness programs.

IT Security Field Operations

The Information Technology Security Field Operations (ITSFO) integrates all the components of security—physical, personnel, and information—to ensure the IRS can continue to perform its critical,

mission-essential functions and services while protecting its assets and facilities. The mission of ITSFO is to provide service and support in all aspects of information security.

Computer Systems Incident Response Center and Information Systems Disaster Recovery

The IRS Computer Security Incident Response Capability (CSIRC) and Information Systems Disaster Recovery organization is responsible for protecting the data and computing resources on the IRS network and keeping computing environments safe from external intrusion. The CSIRC is equipped to identify, contain and eradicate cyber threats targeting IRS computing assets. The four major CSIRC operational functions of prevention, detection, response and reporting meet FISMA requirements for incident response and reporting. In addition, CSIRC and Information Systems Disaster Recovery organization serves as the coordination point for information systems disaster recovery planning and management.

Technical Control Testing and Evaluation

The Technical Control Testing and Evaluation (TCTE) organization performs certification and accreditation support, contract site reviews, lockbox reviews, and readiness reviews. TCTE reviews, analyzes, and provides feedback concerning customer submitted certification and accreditation documentation. For certification and accreditation support, TCTE coordinates the security testing and evaluations (ST&Es). The ST&Es are conducted to provide an independent assessment of the security controls of an information system, for either a major application or general support system (GSS). As a result of the emerging use of contract sites to process IRS information, TCTE performs reviews of security controls to ensure the sites are adequately protecting sensitive but unclassified information. For banks that collect IRS monies, lockbox reviews are conducted to ensure that banks are adequately protecting information and facilities. TCTE performs the IT security component of the lockbox review. The readiness review, which is in the pilot phase, assesses the effectiveness of security controls prior to a GAO or TIGTA visit.

B. Emergency Management and Physical Security

The Emergency Management and Physical Security Office provides program management and coordination to ensure that the disciplines of physical security and emergency management are operating in an integrated manner to serve IRS facilities and critical business operations. Within the Emergency Management and Physical Security Office there are three organizations: the Emergency Management Program Office, Physical Security Program Office, and Emergency Management and Physical Security Field Operations.

Emergency Management Program Office

The Emergency Management Program Office supports the creation of an operational environment within the IRS that is able to withstand systemic discontinuities or catastrophic events. Specific areas of responsibility include managing the Continuity Planning Program, supporting Business Resumption/Incident Management Plan development, and identifying and analyzing threats, strengths and weaknesses and the level of resilience within the IRS operating environment. In addition, the Emergency Management Program Office serves as the coordination point for Continuity of Operations planning (COOP) and management for IRS, and works with the Department of the Treasury to manage the Critical Infrastructure Protection (CIP) program for IRS.

Physical Security Program Office

The Physical Security Program Office ensures the appropriate level of physical security is maintained for all IRS facilities, personnel, and assets. The program office develops physical security procedures and facility design/construction standards. Specific areas of responsibility include guard force contract management, physical security reviews, risk assessment and oversight, ID media, and the canine (K-9) security screening program.

Emergency Management and Physical Security Field Operations

The role of Emergency Management and Physical Security Field Operations (EM&PSFO) is to implement and execute agency-wide policy, procedures, and standards to ensure that emergency management and physical security is in place for the protection of IRS employees, tax returns, monies, property, facilities, and records. For physical security, field operations is involved with IRS facility and property protection, information protection, security awareness, and identification media. EM&PSFO serves as the "driver" in emergency situations and ensures that the requisite IRS organizations take action to meet customer needs and minimize disruption to business.

C. Personnel Security and Investigations

The Personnel Security and Investigations Office ensures that the employment or retention of employees at the IRS is consistent with the interests of national security, the efficiency of the Federal service, and the integrity of the tax system. The office conducts high quality, fair, and impartial suitability and security investigations in a timely manner to mitigate risks of employing untrustworthy or unsuitable individuals. The results of investigations are then used to make determinations about allowing access to facilities, systems, and/or data, or to grant access to classified information through issuance of a National Security clearance. Within the Personnel Security and Investigations Office there are three subordinate organizations: Policy, Planning, and Adjudications; Field Operations; and National Background Investigations Center.

Policy, Planning, and Adjudications

The Policy, Planning, and Adjudications organization provides the overall administration for Personnel Security and Investigations Office by developing and implementing policy, procedure, and guidance. The Policy, Planning and Adjudications organization issues program guidance and direction in accordance with Treasury standards. In addition, this organization provides the resources support needed to carry out the investigative workload of Personnel Security and Investigations, including planning and budgeting, and the management of information systems.

Field Operations

The Field Operations organization performs investigative activities for personnel security investigations on applicants, IRS employees, contractor employees, and other Treasury Bureau employees to provide a basis for determining suitability for employment, or for access to IRS systems, data, facilities, or National Security classified information.

National Background Investigations Center

National Background Investigations Center (NBIC) performs personnel security/suitability investigations on applicants, IRS employees, contractor employees, and other Treasury Bureau employees to provide a basis for determining suitability for employment, or for access to IRS systems, data, facilities, or National Security classified information.

D. Office of Privacy and Information Protection

Within the Office of Privacy and Information Protection there are three subordinate organizations.

Privacy and UNAX

The Office of Privacy is responsible for identifying privacy risks and developing mitigation strategies to enable informed risk-based decisions concerning the type of information that is collected, shared, stored, processed and procured. The mission of the Office of Privacy is to ensure that IRS policies and programs protect taxpayer and employee privacy. The Office of Privacy will achieve its mission, by institutionalizing privacy as a core value across the IRS enterprise through the four program areas: Policies and Procedures, Communications, Operations, and Assurance. In addition to these program areas, the Office of Privacy has expanded its scope to include the Unauthorized Access (UNAX) Program.

Safeguards

The Safeguards organization provides oversight to external agencies in protecting Federal tax information (FTI) and to internal customers in protecting FTI, employee information and other official use only information for contracting purposes. Safeguards ensures that agencies authorized to receive FTI are protecting the data in accordance with policy and legal requirements. Safeguards conducts sensitive but unclassified (SBU) contract document reviews for all new contracts to ensure that disclosure language is appropriate to protect tax information. To perform safeguard reviews, Safeguards personnel visit the state child support, welfare and revenue agencies as well as Federal agencies authorized to receive FTI.

HSPD-12 Program Office

The Homeland Security Policy Directive - 12 (HSPD-12) Program Office is a centralized management organization with a charter to lead the IRS implementation of the HSPD-12 requirements. As such, the program office operates in a matrix manner, with staffing for the program office changing over time responsive to the phases of program implementation. The HSPD-12 Program Office coordinates implementation of HSPD-12 requirements across all IRS organizations and works in partnership with the Department of Treasury to ensure consistency of approach throughout the Department.

E. Strategic Planning and Resources

The Strategic Planning and Resources Office provides planning, program management, integration and resource management support to all MA&SS organizations. This office spearheads the development of strategic and program plans which serve as the basis for budget submissions. By serving as an integration organization for issues that span multiple MA&SS organizations, the Strategic Planning and Resources

Office ensures that customers receive the best possible service and complex issues are addressed timely and completely. In addition, the Strategic Planning and Resources Office serves as a central point for management of internal information management tools and communication both within IRS and externally on mission assurance-related topics.

F. Audit Activity Management

The Audit Activity Management (AAM) organization manages the ongoing Government Accountability Office (GAO) and Treasury Inspector General for Tax Administration (TIGTA) audit activities that are related to security. This involves coordinating entrance and exit conferences, providing information to GAO and TIGTA, coordinating review of all documents, and providing management responses to findings. AAM manages the inventory of GAO recommendations and TIGTA corrective actions, which includes monitoring due dates and status to achieve timely closure. When an audit in another business unit impacts MA&SS, AAM coordinates a unified MA&SS response and collaborates across organizational boundaries to resolve audit findings.

G. Risk Factors and Challenges Affecting Achievement of the Vision

There are a number of external and internal factors to be considered when determining the strategies and operational priorities to achieve MA&SS' vision.

External Factors:

Terrorism Threat

As noted in the IRS Strategic Plan, "Terrorism remains an imminent threat to national security and future terrorist attacks aimed at critical national infrastructure, including our system of tax administration, could produce even more drastic results than those experienced after 9/11." The terrorism threat has grown to include the threat of cyber-terrorism. The threat of terrorism drives the need for ensuring the security of IRS assets and ensuring the continuity of national essential and critical IRS business processes.

Identity Theft

Identify theft represents an emerging threat that affects every citizen and all organizations that transact financial activities with citizens. Skilled identity thieves use a variety of methods to gain access to personal information. For example, they may steal mail, including bank and credit card statements, credit card offers, new checks and tax information. Once identity thieves have acquired personal information, they may use it to commit fraud or theft. Identity thieves can use stolen personal data to file fraudulent tax returns. For example, the IRS recently warned the public of a fraudulent scheme that uses fictitious bank correspondence and IRS forms in an attempt to trick taxpayers into disclosing their personal and banking data. The information is then used to steal the taxpayers' identity and bank account deposits. The Treasury Inspector General for Tax Administration (TIGTA) investigates a wide variety of offenses, including identity theft related to tax administration, and the misuse of IRS insignia, seals and symbols. The threat of identity theft requires a security program that is sensitive and responsive to the changing threat environment in this area, including not only physical and cyber controls, but also building awareness on the part of IRS employees, partners and taxpayers.

Increased use of Electronic Commerce

The increased use of the Internet (including e-commerce and e-mail) and reliance on global infrastructure to support tax administration business processes as well as internal IRS business processes makes possible significant improvements in services provided to IRS customers. However, it also increases the vulnerability of IRS systems and data to unauthorized access or damage from viruses. This drives the need for a robust information security program.

Meeting Regulatory Requirements

All Federal agencies, including the IRS, are subject to regulatory requirements that promote the security of agency assets and assurance of agency business processes. Wide-reaching regulatory requirements, including the Federal Information Security Management Act (FISMA) and OMB capital planning efforts drive significant efforts in ensuring performance, identification of material weaknesses, development of plan of actions and milestones (POA&M), incident reporting and analysis, and training. Federal Preparedness Circular 65 (FPC 65) also drives the continuity of operations focus and requirements for the agency.

Internal Factors:

Business Systems Modernization

The IRS is in the midst of a multi-year, multi-billion dollar business systems modernization program (IRS Strategy 3 – *Modernize the IRS through its people, processes, and technology*). This ongoing program drives the need to ensure that security and resilience considerations are incorporated in all phases of the modernization program.

Current IRS Security Posture

As of late FY 2005, the IRS has ongoing security implementation challenges, including security-related material weaknesses that are in the process of being addressed.

Realignment of the Mission Assurance and Security Services Organization

During FY2005, Mission Assurance and Security Services has undergone two realignments to incorporate emerging organizations and also to respond to new requirements and challenges. Each realignment requires management attention to address start-up and administrative issues, diverting resources temporarily from program activities. Program and project management disciplines instituted during the 2004 realignment are maturing and continue to be refined to meet the needs of both program managers and the senior management team. The MA&SS senior management is focused on continuous improvement to meet customer needs and address mandatory regulatory requirements.

Need to Collaborate With and Support Internal Customers

Mission assurance and security at the IRS is a shared responsibility between MA&SS and all other IRS organizations. One of the primary challenges in assurance and security is providing support to other IRS organizations so that they have the capabilities to successfully implement their security, continuity and assurance roles. MA&SS customers need to become pro-actively engaged in and take ownership of

security and assurance they can sustain their business processes. This responsibility for security and assurance drives the need to establish collaborative processes and structures.

Interdependent Nature of IRS Business Processes

Each year, IRS critical business processes become increasingly interdependent with other Federal agencies and the private sector (e.g., use of lock-box banks to process remittance transactions). These interdependencies drive the need to ensure cross-organizational security and resilience issues are identified and addressed (and risk assessed) in a collaborative manner.

H. Key Partners in Achieving Strategic Strategies

Assuring achievement of the IRS mission is a shared responsibility across all IRS elements. MA&SS provides overall mission assurance leadership, operations support, and promotes collaborative ownership and decision making with all IRS organizations. Business process owners are responsible for the assurance (continuity) of their business processes and asset owners are responsible for all aspects of the security for their assets.

Each IRS organization is responsible for the safety and security of its people (employees and contractors), facilities, technology, and data, in collaboration with and with operations support from MA&SS. Designated information system owners— including all IRS Business Operating Divisions, the CIO, Modernization Information Technology Services (MITS), Chief Counsel, Criminal Investigations and Appeals—are responsible for the security of the systems. Agency Wide Shared Services (AWSS) is responsible for the safety of IRS facilities.

IRS organizations responsible for tax administration (e.g., Services and Enforcement) and business processes supporting tax administration (e.g., Operations Support and the Office of the Commissioner) are responsible for the assurance of their business processes, which requires the development of business continuity capabilities that ensure critical business processes and essential functions can continue to be performed in the event of a disruption.

MA&SS partners with Treasury Department offices which are engaged in major security initiatives that span all bureaus and respond to government-wide mandates. The program management of Homeland Security Policy Directive - 12 requirements is one example of this partnership, Critical Infrastructure and Continuity of Operations are further examples and IRS responsibilities.

To achieve a high and matured level of information technology/information systems assurance through FISMA compliance activities and other information technology security initiatives, MA&SS works closely with security personnel within program management offices located in IRS organizations, which are responsible for tax administration (e.g., Services and Enforcement) and business processes supporting tax administration (e.g., Operations Support).

Lockbox reviews are conducted, as a support effort to Wage and Investment to ensure banks that collect IRS monies, are adequately protecting information and facilities. The Technical Control Testing and Evaluation organization is responsible for the IT security scope of this review.

The MA&SS Personnel Security and Investigations Office worked very closely with Wage and Investment (W&I), Small Business/Self-employed (SBSE) and MA&SS to ensure that contract language

requiring background investigations is included in the Filing and Payment Compliance (F&PC) contracts to outsource collection of federal taxes.

In addition, MA&SS partners with external organizations such as the Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO). MA&SS uses the results of TIGTA and GAO audits to identify risks and regulatory compliance issues and to provide an independent external audit based review of IRS and MA&SS programs.

October 01, 2005

Criminal Investigation Annual Business Plan
FY 2006

The Annual Business Plan sets forth priorities and direction for Criminal Investigation (CI) business operations for FY 2006. This guidance is intended to assist area and field offices in developing local plans to support the CI strategies in accordance with the IRS long-term strategic goals and objectives.

The IRS identified three major strategic goals with specific objectives in its 2005-2009 Strategic Plan. These goals and objectives listed below provide CI with general direction and guidance.

IRS Strategic Goals and Objectives:

I. **Improve Taxpayer Service**
- **Improve service options for the taxpaying public.**
- **Facilitate participation in the tax system by all sectors of the public.**
- **Simplify the tax process.**

II. **Enhance Enforcement of the Tax Law**
- **Discourage and deter non-compliance with emphasis on corrosive activity by corporations, high income taxpayers and other contributors to the tax gap.**
- **Ensure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law.**
- **Detect and deter domestic and off-shore based tax and financial criminal activity.**
- **Deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance or other unintended purposes.**

III. **Modernize the IRS Through its People, Processes and Technology**
- **Increase organizational capacity to enable full engagement and maximum productivity of employees.**
- **Modernize information systems to improve service and enforcement.**
- **Ensure the safety and security of people, facilities and information systems.**
- **Modernize business processes and align the infrastructure support to maximize resources devoted to frontline operations.**

Criminal Investigation supports these goals and objectives through the following compliance, business, and communication strategies:

- ***Maintain focus on legal source tax investigations, including partnering with IRS operating divisions to deploy a successful Fraud Referral Program.***

- ***Effectively work with the Department of Treasury, the Department of Justice, and other law enforcement partners to enforce tax laws and criminal statutes to combat corporate fraud, terrorism, and the financial aspects of other criminal activity, and to enhance Bank Secrecy Act compliance efforts.***

- ***Increase workforce productivity through improvement in recruitment, diversity, retention and strengthened leadership.***

- ***Increase efficiency and quality through improvements in business systems and the reduction of investigative cycle time.***

- ***Maximize the impact of criminal enforcement through education and outreach.***

To support its strategies and objectives, CI will continue to emphasize core mission tax administration cases. Investigative priorities remain in the following order:

- Legal source tax crimes
- Illegal source tax and financial crimes
- Terrorist financing and narcotics related financial crimes, consistent with the Organized Crime Drug Enforcement Task Force (OCDETF) appropriation level

Compliance Strategies

- ***Maintain focus on legal source tax investigations, including partnering with IRS operating divisions to deploy a successful Fraud Referral Program.***

- ***Effectively work with the Department of Treasury, the Department of Justice, and other law enforcement partners to enforce tax laws and criminal statutes to combat corporate fraud, terrorism, and the financial aspects of other criminal activity, and to enhance Bank Secrecy Act compliance efforts.***

Criminal Investigation will maintain or increase its investigative resources on legal source tax investigations by working closely with the other operating divisions to develop and investigate cases on significant violators. Additionally, CI will pursue significant investigations involving illegal source tax and other financial crimes, including money laundering, that adversely affect tax administration.

Only through strong proactive case development can CI meet these compliance strategies. Criminal Investigation will continue to build strong relationships with other IRS operating divisions, the United States Attorneys' Offices (USAO) and other law enforcement agencies, both foreign and domestic, to develop significant tax and other financial investigations. To identify high-impact investigations involving non-compliant industries, schemes, and individuals, CI will use all available resources including proactive participation on task forces, case development projects, and Suspicious Activity Report (SAR) Review Teams. The operational priorities under these strategies are the following:

Fraud Referral Program
Criminal Investigation will continue to strengthen the Fraud Referral Program by working closely with Small Business/Self Employed (SB/SE), Large and Mid-Sized Business (LMSB), Tax Exempt/Government Entities (TE/GE) and Wage and Investment (W&I) to promote fraud awareness and assist with fraud training. Each field office will maintain a fraud referral coordinator. Field offices will also ensure the timely evaluation of fraud referrals within 45 days, and include the civil functions in the formulation of work plans on joint investigations.

Abusive Tax Schemes
Investigations on the promoters and culpable clients of abusive tax schemes continue to be a priority. Criminal Investigation will strengthen partnerships with SB/SE, LMSB, and TE/GE to identify corrosive schemes, offshore and domestic, and other methods of tax evasion that erode voluntary compliance. In addition, CI will continue to coordinate with the civil functions to conduct parallel civil and criminal actions to stop abusive tax promotions and prevent the unnecessary proliferation of abusive schemes. Criminal Investigation will also collaborate with civil operating divisions to ensure the prompt examination of abusive scheme clients/investors.

Corporate Fraud
Criminal Investigation will work with LMSB to identify and investigate alleged violations by corporate officers and executives. To identify and investigate high-impact corporate fraud cases, CI will also work with the USAOs, the Federal Bureau of Investigation (FBI), the Securities and Exchange Commission, and other federal and state agencies. Field office corporate fraud coordinators will serve as liaisons with LMSB to facilitate LMSB referrals.

Refund Crimes
Criminal Investigation will continue to combat refund-related crimes, including prisoner schemes, and schemes using Business Master File (BMF) returns, through its Questionable Refund and Return Preparer Programs. Unscrupulous tax return preparers who promote abusive or fraudulent refund schemes will continue to be a focus of CI's efforts. Criminal Investigation will partner with the civil operating divisions to ensure prompt examinations of abusive scheme clients.

Non-Filer
Criminal Investigation will aggressively develop investigations on high-income, high-impact non-filers, through the use of general investigations and strengthened partnerships with SB/SE, LMSB, and Wage and Investment. Through this program, CI will pursue the development of significant investigations covering a broad spectrum of occupations and professions.

Employment Tax
In its continued effort to support service-wide efforts to enhance employment tax compliance, CI will develop egregious, high dollar employment tax cases involving a wide array of industries and professions.

Money Laundering/Financial Criminal Activity
Concentrating its anti-money laundering efforts on investigations that adversely affect tax administration, CI will continue to work with USAOs to investigate significant, high impact financial investigations, and support the efforts of the High Risk Money Laundering and Related Financial Crimes Area Task Forces, the National Wire Remitter Project, and SAR Review Teams.

Bank Secrecy Act
Criminal Investigation will strengthen communication and coordination with SB/SE Fraud Technical Advisors and Bank Secrecy Act (BSA) Examiners, and with the Financial Crimes Enforcement Network (FinCEN) to identify and investigate criminal violations of the BSA. The goals of this program are to identify significant legal and illegal source tax cases in addition to, money laundering, asset forfeiture, terrorist financing and narcotics investigations. To strengthen BSA compliance efforts, CI will aggressively develop BSA investigations through the National Wire Remitter Project including investigations of money services businesses.

Counterterrorism
Criminal Investigation will give full and immediate attention to counterterrorism leads and continue to contribute financial investigative expertise and resources to the FBI's Joint Terrorism Task Forces (JTTF) and the USAOs' Anti-Terrorism Task Forces. To assist in disrupting and dismantling terrorist financing, CI will use its expertise to analyze complex financial information. Criminal Investigation will also work closely with the Treasury Office of Terrorism and Financial Intelligence, and Office of Foreign Assets Control to investigate and freeze accounts controlled by individuals, "charitable" organizations, or hawalas suspected of raising or facilitating the movement of funds to support terrorism both foreign and domestic. Additionally, Criminal Investigation will provide nationwide research and project support on terrorist financing investigations through the Garden City-Lead Development Center.

Organized Crime Drug Enforcement Task Force (OCDETF)
Criminal Investigation will support the National Drug Control and Money Laundering Strategies by committing appropriate resources to OCDETF and High Intensity Drug Trafficking Area investigations commensurate with appropriated funding levels. Criminal Investigation will use its financial investigative expertise and resources to dismantle and disrupt major narcotics trafficking/money laundering organizations and forfeit their illegal profits.

Asset Forfeiture
Criminal Investigation will continue to properly pursue asset forfeiture. Field offices will ensure that CI agents consult and coordinate with Asset Forfeiture Coordinators (AFC) at the earliest stages of seizure planning. Further, CI special agents will maximize opportunities to serve as affiants for seizure warrants. Field office Special Agents in Charge and AFCs will vigilantly guard against inequitable reductions to CI's reverse sharing requests.

Business Strategies

- ***Increase workforce productivity through improvement in recruitment, retention and strengthened leadership.***

Criminal Investigation will emphasize employee productivity and effectiveness through development, skills transfer, and improved communication. The operational priorities under this strategy are to:

Identify and Develop CI Leadership Candidates
Criminal Investigation will identify and properly develop future leaders to ensure the continued accomplishment of our goals and objectives. To provide for a strong and consistent leadership team, CI will address barriers to program participation and provide developmental opportunities and progressively responsible assignments in support of all the Frontline Leader Readiness and the Leadership Development Programs.

Recruit High Caliber Employees
To recruit quality candidates for both special agent and non-1811 positions, CI will continue to partner with full-time recruiters, the Human Capital Office and the office of Equal Employment Opportunity and Diversity. Criminal Investigation will also continue to attract qualified candidates through the Student Career Experience Program.

Maintain a Knowledgeable Workforce
Criminal Investigation will continue its focus on knowledge management to facilitate skills and knowledge transfer. To retain its collective expertise and technical skills, CI will evaluate workforce developmental needs and provide appropriate mentoring, training, and growth opportunities. Criminal Investigation will also encourage and facilitate the use and expansion of CASE (Communities Accessing and Sharing Expertise).

Foster Clear Communication
Clear and frequent communication is key to effective leadership, teamwork, and progress. Criminal Investigation will take proactive steps to improve communication, i.e. through face-to-face interaction, when possible. Employees at all levels must communicate in a timely and effectual manner. Further, CI management is responsible for ensuring employees are well informed of their performance expectations and roles in supporting the strategic goals.

Improve Employee Satisfaction and Engagement
Criminal Investigation will identify and address barriers impeding the full engagement of employees. This will entail taking appropriate action in response to employee concerns raised through the employee satisfaction survey process, the advisory counsel programs, as well as the Ask the Chief and Employee Suggestion programs. Management will also provide timely employee performance appraisals and properly recognize achievements.

Business Strategies-*continued*

- ***Increase efficiency and quality through improvements in business systems and the reduction of investigative cycle time.***

Criminal Investigation continues to develop and enhance processes and programs to improve investigative efficiencies and reduce administrative burden without sacrificing quality. The following are operational priorities under this strategy:

Improve Criminal Investigation Management Information System (CIMIS) Timeliness and Accuracy
Criminal Investigation field office management and employees are responsible for promptly and correctly entering and updating data, as well as periodically validating CIMIS information to ensure accuracy. Field offices will enter CIMIS updates within five calendar days of triggering events. Criminal Investigation will also take action to ensure CIMIS accurately tracks investigative equipment inventories, as required.

Improve Efficiency and Reduce Elapsed Time on Criminal Subject Investigations
To reduce elapsed time, CI will promptly take investigative actions, effectively use all available resources, and make timely decisions relative to case matters striving for the range of 415 to 425 elapsed days on completed Legal/ Illegal source Subject Criminal Investigations. Through appropriate management oversight and direction, CI will maintain optimum workload levels and ensure all investigations progress appropriately. Criminal Investigation will be cognizant of taking these critical actions without sacrificing the quality aspect of its investigations.

Criminal Investigation, through the Electronic Crimes Section, will enhance its ability to receive, analyze, and process electronic evidence. When available, CI will request and facilitate electronic submission of summonsed or subpoenaed financial records. Criminal Investigation will also continue to upgrade and enhance its automated processes.

Communication Strategy

- **Maximize the impact of criminal enforcement through education and outreach.**

Criminal Investigation will vigorously capitalize on media and other outreach opportunities, to maximize publicity of our investigations and educate the American public on schemes and scams. The operational priorities under this strategy are:

Communication Outreach
Criminal Investigation's Office of Communications and Education will continue to support the IRS mission and compliance strategies through comprehensive media outreach activities directed at national and regional audiences, market segments, and the World Wide Web.

Coordinate with Public Information Officers
Communications and Education and field personnel will coordinate with field office public information officers to enhance the impact of CI cases through the media. Field offices will also collaborate with Headquarters Communications and Education on publicity and outreach activities designed to alert the public to emerging tax schemes, scams and cons.

IRS Human Capital Strategic Implementation Plan

2006-2007

Human Capital Office

Linking Human Achievement with Business Results

Introduction

IRS Employee Facts		
Total IRS Employees as of January 2006 = 103,064 (TIMIS Data as of January 7, 2006)		
Non-Seasonal 83,325 Seasonal 19,739	Management 8,923 Management Officials 3,004 Non-Management 91,137	Bargaining Unit 82,778 Non-Bargaining Unit 20,286
Average Age 47.72	Average Years of Service 16.58	Projected Retirement Eligible for FY'04 thru FY'08 30,468

The Internal Revenue Service (IRS) is the largest bureau in the Department of Treasury, our 103,064 employees representing approximately 81% of Treasury's total population. The IRS is responsible for collecting the revenues that fund most public services.

The IRS workforce is widely diverse in many ways, including job series, ethnicities, and geographic distribution. IRS has a large seasonal workforce that accounts for upward of 23% of our population during peak workload seasons. Between 76 and 77% of the IRS annual budget is dedicated to financing our "human capital". As stewards of this investment, we are challenged with workforce retention and replenishment, succession planning, leadership continuity, and competency gap assessment and resolution.

For the purpose of this document, all organizations of the IRS - including operating divisions, specialized units and support functions - are referred to collectively as business units (BUs).

"A company's human capital asset is the sum of the talent, energy, knowledge, and enthusiasm that people invest in their work."
- Jeanne DiFrancesco, ProOrbis

Human Capital Commitment

The IRS takes seriously the charge of strategically managing its human capital. We have already developed an IRS Human Capital Strategic Plan (HCSP) for 2005 to 2009. We are herein pleased to announce the development of this Internal Revenue Service Human Capital Strategic Implementation Plan for Fiscal Years 2006-2007.

This Plan is the complement to the HCSP. It offers sound business strategies designed to address the IRS' workforce challenges and to achieve our vision of the desired future state of human capital in IRS. The HCSP is strategically aligned to ensure a clear line of sight between the Treasury and IRS strategic business goals. It includes an analysis of the gap between the current state of human capital within the IRS and the desired future state. The HCSIP uses strategy mapping as a tool to define and prioritize objectives, processes, and projects over the next two years. The IRS HC Strategy Map will assist the IRS in meeting both Human Capital and IRS strategic objectives and close the gaps identified by the HCSP. Further, the HCSIP establishes measures for monitoring our performance toward achieving these objectives, processes and projects. This corporate approach to managing our human capital ensures that the IRS builds and maintains the workforce needed to carry out its mission in an efficient and effective manner, therefore, "Linking Human Achievement with Business Results".

Linking the Human Capital Strategic Plan with Implementation

The table below identifies the scope and linkage of the Human Capital Strategic Plan and the Implementation Plan. As a tactical approach to implementing strategy, the Implementation Plan focuses on delivery of specific program/initiatives over a two year period. Perhaps more importantly the Implementation Plan is a "rubber meets the road" approach to carrying out our strategy and then analyzing metrics and monitoring projects as indicators of our performance.

Human Capital Strategic Plan	Human Capital Strategic Implementation Plan
▪ Sets the strategic direction for human capital management over the next 5 years ▪ Establishes a clear line of sight between the Treasury and IRS Strategic and Human Capital Strategic Plans ▪ Identifies gaps and recommends strategies to address them	▪ Outlines the specific human capital objectives/processes/projects to support and achieve the HCSP goals and strategies over the next 2 years ▪ Facilitates accountability for performance and results ▪ Establishes systemic corporate quarterly reporting

Human Capital Strategic Goals and Strategies

We began developing our Implementation Plan with a clear understanding of our strategic direction. In 2005, IRS established the following Human Capital Strategic Goals to support the achievement of Treasury and IRS business goals:

Goal 1: Continually Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission – This goal specifies transition and other efforts implemented to achieve both the optimum mix of skills within the IRS and the balance of employees in mission critical occupations (MCOs) and in non-MCOs. Beyond that, this goal strives for the optimum mix of federal workers, contract support and leveraged technology. First class recruitment effort will ensure that the resulting blended workforce reflects balanced, de-layered staffing levels of employees in MCOs and those in supporting functions as well as a diverse, competent and citizen-centered workforce.

Goal 2: Increase Employee Proficiency and Engagement to Enhance Tax Law Compliance – This goal targets our efforts in training, retention and employee engagement. Properly executed, the planned efforts should ensure a highly productive and engaged workforce able to accomplish the mission of the Service.

Goal 3: Leverage Human Capital Technology to Reduce Burden – This goal focuses exclusively on human capital systems designed to deliver services through user-friendly electronic means that reduce burden to the user as well as the customer. These systems also create linear work streams that maximize one-stop processing and self-service methods and eliminate process redundancies.

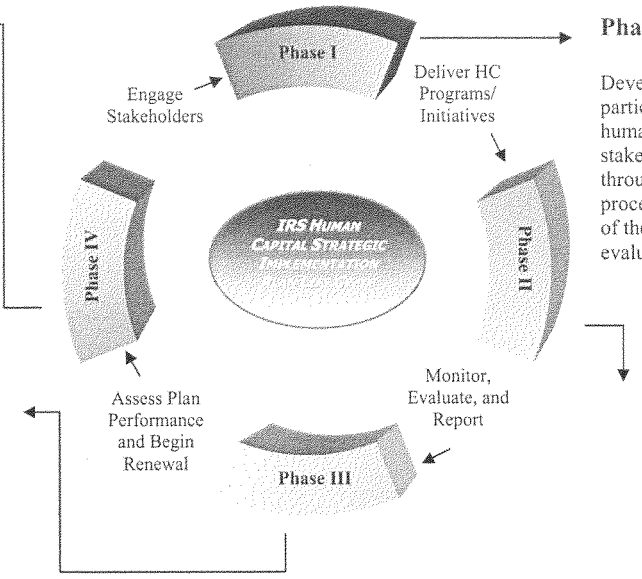
Goal 4: Enable Quick and Agile Management Action to Achieve Business Goals – The intent of this goal is to create an organizational culture that removes barriers that impede the achievement of business goals. This is accomplished in part through collaboration between management, employees, the union and other external stakeholders. This collaboration includes, but is not limited to, management/labor cooperation, leveraged relationships with employee special interest groups, colleges, universities, professional organizations and oversight entities.

Human Capital Strategic Implementation Plan Life Cycle

The development of the Implementation Plan is based upon a sustainable repeatable process, the HCSIP life cycle. This cycle ensures stakeholder involvement and establishes a meaningful and agile process for prioritizing objectives, processes and projects; assessing performance through indicators; and making needed adjustments to promote a business culture focused on human capital excellence and continuous improvement.

Phase IV – *Assess Plan Performance and Begin Renewal*

Using data collected from the metrics, assess overall plan performance and make needed adjustments for improvement and plan renewal.



Phase I – *Engage Stakeholders*

Development of the Plan begins with participation from executives, managers, human capital professionals and external stakeholders. Engagement is demonstrated through each group's involvement in the process from development and validation of the strategy map to ownership and evaluation of performance and results.

Mapping Human Capital Alignment

We used Strategy Mapping as a tool to align organizational human capital objectives with business goals and then to identify and prioritize the strategies and activities needed to realize these objectives. To ensure stakeholder engagement in the process, we established three teams as follows:

- ***The Leadership Team*** consisting of members of the Human Capital Board, the Deputy Commissioner or similar rank from each business unit, and the Deputy Chief Human Capital Officer.

- ***The Scorecard Team*** consisting of members of the Human Capital Advisory Council (HCAC) and representatives from support functions such as the Office of Program Evaluation and Risk Assessment (OPERA) and Office of the Chief Financial Officer (OCFO).

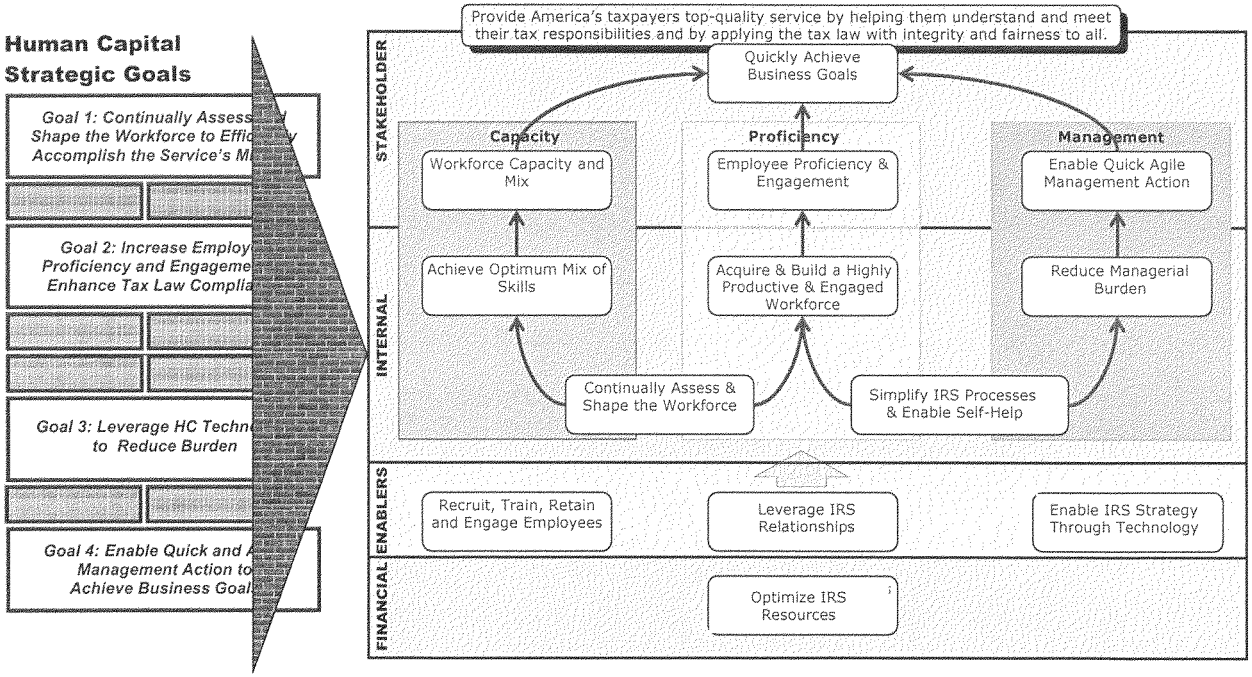
- ***The Indicators Team*** consisting of members of the Human Capital Planning Sub-Council, including representatives of the Chief Financial Officer (CFO), Agency-Wide Shared Services (AWSS) and OPERA employees with expertise in a comprehensive range of human capital processes/projects, metrics and technology.

Additional input was provided from external stakeholders including the Office of Personnel Management (OPM), Department of Treasury, The Performance Institute, and the IRS Oversight Board.

The Leadership Team, responsible for setting strategic direction, used the four Human Capital Strategic Goals to develop the IRS Human Capital Strategy Map. The team looked at these goals from four main perspectives: stakeholders, internal business processes, business enablers, and financial to define Strategic Objectives. Once the Strategic Objectives were identified the Leadership Team assigned weights based on business priorities.

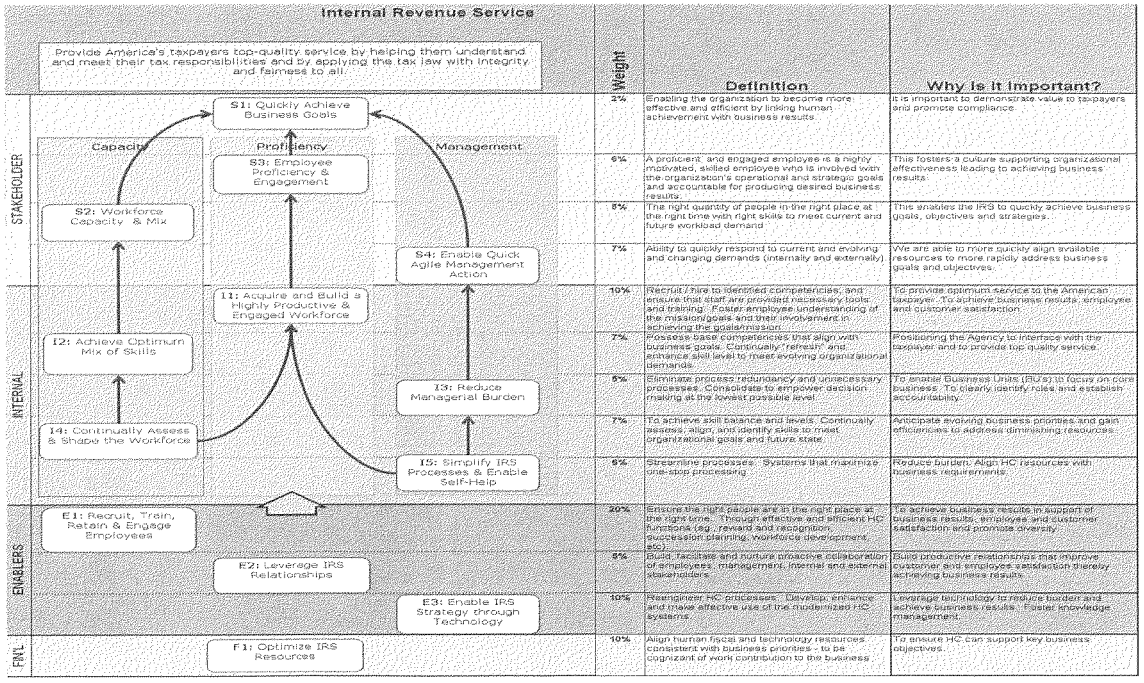
Phase I

Human Capital Strategic Goals Set the Foundation



Phase I

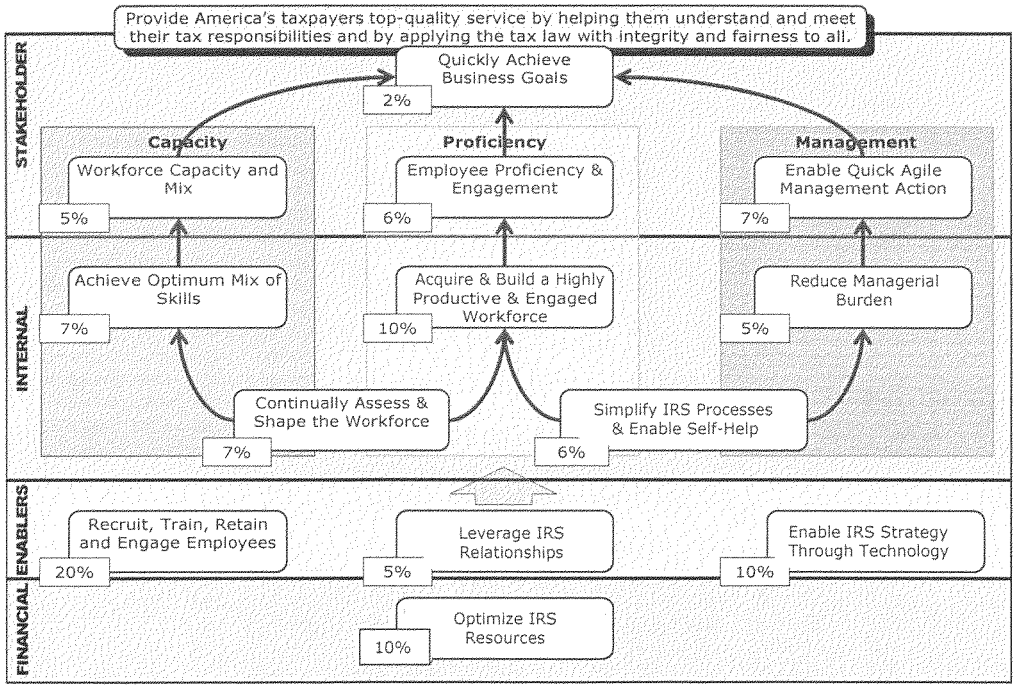
Strategy Mapping Teams Reach a Common Understanding



Weight	Definition	Why Is It Important?
2%	Enabling the organization to become more effective and efficient by linking human achievement with business results.	It is important to demonstrate value to taxpayers and promote compliance.
6%	A proficient and engaged employee is a highly motivated, skilled employee who is involved with the organization's operational and strategic goals and accountable for producing desired business results.	This fosters a culture supporting organizational effectiveness leading to achieving business results.
8%	The right quantity of people in the right place at the right time with right skills to meet current and future workload demand.	This enables the IRS to quickly achieve business goals, objectives and strategies.
7%	Ability to quickly respond to current and evolving and changing demands (internally and externally)	We are able to more quickly align available resources to more rapidly address business goals and objectives.
10%	Recruit / hire to identified competencies, and ensure that staff are provided necessary tools and training. Foster employee understanding of the mission/goals and their involvement in achieving the goal/mission.	To provide optimum service to the American taxpayer. To achieve business results, employee and customer satisfaction.
7%	Possess base competencies that align with business goals. Continually "refresh" and enhance skill level to meet evolving organizational demands.	Positioning the Agency to interface with the taxpayer and to provide top quality service.
5%	Eliminate process redundancy and unnecessary processes. Consolidate to empower decision making at the lowest possible level.	To enable Business Units (BU's) to focus on core business. To clearly identify roles and establish accountability.
7%	To achieve skill balance and levels. Continually assess, align, and identify skills to meet organizational goals and future state.	Anticipate evolving business priorities and gain efficiencies to address diminishing resources.
6%	Streamline processes. Systems that maximize one-stop processing.	Reduce burden. Align HC resources with business requirements.
20%	Ensure the right people are in the right place at the right time. Through effective and efficient HC functions (eg., reward and recognition, succession planning, workforce development, etc.)	To achieve business results in support of business results, employee and customer satisfaction and promote diversity.
5%	Build, facilitate and nurture proactive collaboration of employees, management, internal and external stakeholders.	Build productive relationships that improve customer and employee satisfaction thereby achieving business results.
10%	Reengineer HC processes. Develop, enhance and make effective use of the modernized HC systems.	Leverage technology to reduce burden and achieve business results. Foster knowledge management.
10%	Align human fiscal and technology resources consistent with business priorities - to be cognizant of work contribution to the business.	To ensure HC can support key business objectives.

Weighting Objectives Helps Us Focus on Priorities

Phase I



Why Focus on Enablers?

Strengthening the Enabler Objectives will in turn strengthen the Internal and Stakeholder Objectives as well.

- Total weighting of 35%
- Highest weighted objectives
- Manageable number of objectives

Identifying the Critical Few:

From Strategic Objectives to Core Processes
From Core Processes to Key Projects

Once we reached consensus with stakeholders on our human capital strategic objectives and their relative contribution to business success, we next determined how these objectives link to each of our 19 core processes:

1.0 Position Classification/Position Management	11.0 Labor Relations
2.0 Benefits, Retirement and Worklife Programs	12.0 Employee Relations
3.0 Recruitment and Hiring	13.0 HR Technology Development
4.0 Retention	14.0 Human Resources Information Management
5.0 Pay, Leave and Hours of Work	15.0 Human Resources Transactions
6.0 Performance Management, Evaluations and Awards	16.0 Human Capital Governance
7.0 Centralized Customer Support	17.0 Strategic Planning and Evaluation
8.0 Leadership Development	18.0 Workforce Planning
9.0 Employee Development	19.0 Workforce Transition
10.0 Employee Engagement	

The strategy mapping teams spent several days undertaking additional analyses that ultimately identified key projects that can make the greatest contribution toward the achievement of our Human Capital Strategic Objectives. First, we determined which core processes influence each strategic objective. For example, our core process of "Workforce Planning" clearly influences the achievement of our objectives to "Establish Optimum Workforce Capacity and Mix" and "Achieve Optimum Mix of Skills".

In addition to identifying these causal links, the Scorecard Team defined, shared information about, and discussed the progress and challenges of each core process. A key benefit of this discussion was an educational exchange of perspectives between customers and service providers. The primary process owners utilized this significant input along with additional data points from various sources, including customer satisfaction measures, compliance with standards set in business unit service level agreements, and operational measures, to determine the effectiveness of each link. These ultimate determinations, validated by senior leadership, are illustrated by the chart on the following page:

Core Processes Data Supported		Stakeholder				Internal					Enablers			Finance
		S1: Quickly Achieve Business Goals	S2: Workforce Capacity & Mix	S3: Employee Proficiency & Engagement	S4: Enable Quick Agile Mgt Action	I1: Acquire and Build Highly Productive & Engaged Workforce	I2: Achieve Optimum Mix of Skills	I3: Reduce Managerial Burden	I4: Continually Assess & Shape the Workforce	I5: Simplify IRS Processes & Enable Self Help	E1: Recruit, Train, Retain & Engage Employees	E2: Leverage IRS Relationships	E3: Enable IRS Strategy through Technology	F1: Optimize IRS Resources
		2	5	6	7	10	7	5	7	6	20	5	10	10
Processes														
1.0	Position Classification / Position Management													
2.0	Benefits, Retirement and Worklife Programs													
3.0	Recruitment and Hiring													
4.0	Retention													
5.0	Pay, Leave & Hours of Work													
6.0	Performance Management, Evaln's & Awards													
7.0	Centralized Customer Support													
8.0	Leadership Development													
9.0	Employee Development													
10.0	Employee Engagement													
11.0	Labor Relations													
12.0	Employee Relations													
13.0	HR Technology Development													
14.0	Human Resources Information Management													
15.0	Human Resources Transactions													
16.0	Human Capital Governance													
17.0	Strategic Planning & Evaluation													
18.0	Workforce Planning													
19.0	Workforce Transition													

From Core Processes to Key Projects

Stating the links between strategic objectives and core processes and evaluating the effectiveness of these links serves multiple purposes. Principally, it enables us to strategically decide which projects and initiatives are most likely to improve the core processes that link to these objectives. When we have to narrow our focus for resource or other reasons, we can refer to the relative effectiveness of the links to make these important choices.

For this initial HCSIP, we have chosen to focus on the Enabler Objectives:

1. Recruit, Train, Retain and Engage Employees;
2. Leverage IRS Relationships; and
3. Enable IRS Strategy through Technology.

Improving our performance around these objectives will directly benefit the Internal and Stakeholder Objectives as well. Next, we identified six core processes as potentially having the most immediate and significant impact on the Enabler Objectives. The selected core processes are:

- Recruitment and Hiring,
- Leadership Development,
- Employee Development,
- Employee Engagement,
- Labor Relations, and
- HR Technology Development.

We selected these processes because they each link with two or more of the Enabler Objectives, with all links being yellow or red. By ensuring the success of projects that will improve these six core processes, we increase the likelihood of significant improvement in meeting our Enabler Objectives.

We validated the selection of the six core processes by asking whether improving them would substantially address the strategies identified in the Human Capital Strategic Plan. The HCSP identified gaps between the current state and desired future state of human capital in the IRS. Thirty strategies were identified to address these gaps. Our analysis indicated that successfully addressing these six core processes will lead to improvement in 50% of the HCSP Strategies (or 15 out of 30). The positively impacted strategies include:

- Leadership Recruitment and Retention
- Succession Planning
- Employer of Choice
- Hiring Flexibilities
- Continual Replenishment of the Workforce
- Employee Learning and Development
- Assess Workforce Competencies
- Leadership/Management Development
- Leaders who Engage Employees
- Labor Management Relations
- Manager Preparation on Employee Matters
- Effective LR Collaboration
- Leveraged E-learning
- Mitigation of Migration Impact
- Workforce Planning

The Strategy Mapping Teams identified the key projects that will drive this success. They are discussed in more detail in the next two sections.

What Does this Mean for Our Remaining Core Processes?

It is important to note the 13 additional core processes that fall outside of the scope of this Implementation Plan. We will not lose sight of the continued significance of these processes. Our strategy mapping exercise confirms that many of them effectively support our other key objectives. This effectiveness must continue and, wherever feasible, improve. We ultimately need to meet 100% of our objectives. Accordingly, continued progress in all of our programs remains necessary. Indeed, while we expect that, by focusing on six key processes, we will strengthen our ability to meet all of our objectives, this is no substitute for the continued cutting edge thinking that governs the IRS' human capital programs.

Putting the Plan into Action

Phase II

The chart below identifies projects that will drive improvement in the six core processes that have the most immediate and significant impact on the enabler objective. Additionally, we identified the relationship to the Human Capital Strategic Goals. The projects are described in more detail in the section that follows.

Enabler Objectives/ HC Strategic Goals	HCSIP Projects
Enabler Objective: Recruit, Train, Retain & Engage Employees Goal 1. Continually Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission Goal 2. Increase Employee Proficiency and Engagement to Enhance Tax Law Compliance	A web based application that maintains and tracks hiring plans and initiatives by organization, **1.) People Trak –** location, and position; maps new hire data into a Servicewide position management system; tracks internal and external hires; and performs attrition and migration analysis. This robust tool will move us from current multiple tracking and reporting systems to a single system with many uses, including workforce management, hiring initiatives, workforce initiatives, span of control, and competencies for recruitment and training. It will also permit operations support functions to provide one stop service in providing space, equipment, and other on boarding needs for new hires and migrating employees. *Core Process Link – Recruitment and Hiring* **2.) Workforce Flexibilities** - Key statutory provisions affecting recruitment and hiring o Pay administration corrections - ensures consistency in pay-setting o Recruitment, retention and relocation incentives - provides enhanced and expanded flexibility for monetary incentives o Annual leave – authorizes crediting non-federal work experience for leave accrual levels

Enabler Objectives/ HC Strategic Goals	HCSIP Projects
	3.) Hiring Plans – IRS continues to place significant resource allocation toward the recruitment and hiring of talent from both internal and external sources. *Core Process Link - Recruitment and Hiring* **4.) Competency Infrastructure -** Competency models identify the general and technical knowledge, skills and abilities essential to an employee's successful performance in a position. These models are used to identify the competencies needed at entry (recruitment and selection), developed on the job (training and development), measured in performance (performance management), and/or needed for future career planning (career pathing and succession planning). *Core Process Link - Recruitment and Hiring* **5.) Strategic Workforce Plan** – Develop a Workforce Plan that is technologically enhanced to identify workforce trends, gaps and human capital needs across the IRS *Core Process Link - Recruitment and Hiring* **6.) New Employee Orientation –** Standardize and automate new employee orientation to provide current, more robust and consistent on-boarding and establish a foundation for employee engagement. *Core Process Link – Employee Engagement* **7.) Level 3 Training Evaluation –** Level 3 Evaluation is a post-training survey of employees and their managers regarding the extent to which trainees, as a result of training, are fully proficient in performing their job tasks. Surveys are created online and administered via e-mail using Integrated Training Evaluation and Measurement Services (ITEMS) functionalities. Surveys may be based on individual courses or a series of courses (e.g., a curriculum). *Core Process Link – Employee Development*

Enabler Objectives/ HC Strategic Goals	HCSIP Projects
	8.) Strategic Leadership Succession Planning – A comprehensive corporate Leadership Succession Program. *Core Process Link – Leadership Development* **9.) Learning and Education Analysis Project (LEAP) –** A workforce initiative to redesign the Learning and Education organization Servicewide to more efficiently meet the mission of developing and delivering just-in-time, competency-based training. *Core Process Link – Employee Development* **10.) IRS Employee Engagement Program –** Servicewide program to improve organizational performance through the focus on balanced measures at the work group level. Work groups will identify barriers to delivering the organization's goals and objectives as part of their ongoing operations. This process change will address many of the "Q's" that Gallup uses to determine employee engagement. *Core Process Link – Employee Engagement* **11.) Employee Tax Compliance –** A unified employee tax compliance program that incorporates communication and assistance, noncompliance detection and administrative adjudication. *Core Process Link – Employee Engagement* **12.) Targeted Recruitment (Diverse Workforce)** – A multi-year recruitment and marketing plan is used to target a diverse applicant pool. This is coupled with a comprehensive assessment strategy to identify applicants with the knowledge, skills, and abilities (competencies) necessary to meet the needs of the business. *Core Process Link-Recruitment and Hiring*

Enabler Objectives/ HC Strategic Goals	HCSIP Projects
Goal 4. Enable Quick and Agile Management Action Enabler Objective: Leverage HC Relationships to Achieve Business Goals	**13.) National Work Schedule (NWS Agreement)** - Implement a consistent business wide approach to offering work schedules throughout IRS. Eliminate outdated local AWS agreements to ensure consistent application and opportunity for employees. *Core Process Link – Labor Relations* **4.) Labor Management Relations Committees (LMRC) –** The National LMRC will serve as a forum for pre-decisional input and discussion on matters of concern or interest in personnel policies, practices, and working conditions that may have national, cross-functional or local impact on employees. Additionally, the council will be responsible for National Diversity and Equal Employment Opportunity and health and safety issues. Local LMRC's will focus on issues within their geographic SCR area, whether they involve just one Division/Function or all Divisions/Functions in that SCR area. *Core Process Link – Labor Relations* **15.) Term Bargaining –** Term will provide a successor National IRS/NTEU collective bargaining agreement. *Core Process Link – Labor Relations*
Leverage Human Capital Technology To Reduce Burden	**16.) ELMS** -The IRS Enterprise Learning Management System (ELMS) is the e-Learning system architecture that allows the Agency to transition from a classroom-based to a technology-enabled learning and performance-support environment. It is a web-based application that employees, managers, and the learning and education community use to manage training and development. ELMS consists of a Learning Management System (LMS) to administer training and a Learning Content Management System (LCMS) to provide a structured environment to develop, store, maintain, and reuse content. ELMS will be integrated with other IRS applications (virtual conferencing, room scheduling, etc.) and Treasury systems (HR Connect, *CareerConnector*, etc.) to provide comprehensive training support. IRS is a partner with the OPM government-wide e-training initiative (Go Learn), which provides secure hosting facilities for ELMS. *Core Process Link – HR Technology Development*

Enabler Objectives/ HC Strategic Goals	HCSIP Projects
	17.) *CareerConnector* – *CareerConnector* is an applicant management system that provides an online job application (including resume) and automated rating, ranking, and referral of applicants for job consideration and selection. The system has the flexibility to support the variety of recruitment processes used by the IRS to fill its positions under merit promotion (includes internal processes used for management selection, executive selection, and bargaining unit/ non-bargaining unit selection) and the competitive processes used for external recruitment. *Core Process Link – HR Technology Development* **18.) Succession Planning Resource Center –** A centralized repository of succession planning information from front-line managers through executives. Though currently limited to executives, it will be expanded as part of the succession planning project. *Core Process Link – HR Technology Development* **19.) Workforce Analysis Suite –** Technology driven analysis of workforce data elements, including migration analysis, attrition and retirement projections designed to inform management and offer input to business decisions. *Core Process Link – HR Technology Development* **20.) Competency Assessment Center –**A web-based intranet portal whereby the business can deploy general and/or technical assessments in support of internal hiring, training/development, and/or certification processes. Employees and their managers receive immediate feedback on the results of the assessment via email. The center is currently piloting the Field Assistance Technical Assessment Battery. *Core Process Link – HR Technology Development*

Phase III

Implementing the Plan
Key Projects - Where the Rubber Meets the Road

Goal 1: Continually Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission
HCSP Strategy: Develop and deploy a Servicewide system for continual replenishment of our workforce that considers resource limitations.
Strategy Mapping Perspective: Enabler
Strategy Mapping Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Organizational Change Office

Project/Initiative Title: 1. People Trak

Purpose: Data storage, tracking and reporting tool that facilitates one-stop service by Operations Support to provide space, technology and other needs for new hires and migrating employees.	**Desired Outcome:** Move IRS from current multiple tracking and reporting systems to a single system with many uses, including workforce management, hiring initiatives, span-of-control, and competencies for recruitment and training.

Description: A web based application that maintains and tracks hiring plans and initiatives by organization, location, and position; maps new hire data into a Servicewide position management system; tracks internal and external hires; and performs attrition and migration analysis. This robust tool will move us from current multiple tracking and reporting systems to a single system with many uses, including workforce management, hiring initiatives, workforce initiatives, span of control, and competencies for recruitment and training. It will also permit operations support functions to provide one stop service in providing space, equipment, and other on boarding needs for new hires and migrating employees.

Timeline/Milestones:
- Hiring Plans/Tracking for all Business Units completed by 4th quarter FY 2006.

Goal 1: Continually Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission
HCSP Strategy: Dedicate resources and establish policy to ensure that management has the opportunity to use hiring flexibilities (incentives, accelerated steps or recruitment bonuses).
Stategy Mapping Perspective: Enabler
Strategy Mapping Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Workforce Retention and Transition

Project/Initiative Title: 2. Workforce Flexibilities	
Purpose: Enhance personnel authorities and flexibilities relating to pay, recruitment, relocation, and retention (3R) incentives, leave, and compensatory time-off for travel.	**Desired Outcome:** Advance IRS' image as an "Employer of Choice" by providing enhanced means to use monetary and non-monetary benefits as recruitment and retention tools.

Description:
- Key provisions affecting recruitment and hiring
- Pay administration corrections - insures consistency in pay-setting
- Recruitment, retention and relocation incentives - provides enhanced and expanded flexibility for monetary incentives
- Annual leave – authorizes crediting non-federal work experience for leave accrual levels

Timeline/Milestones:
- Pay administration corrections – implemented June 2005
- 3R incentives – implementation June 2006
- Annual leave – implementation June 2006

Goal 1: Continually Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission
HCSP Strategy: Align recruitment activities to support the talent hiring needs of the business/operating divisions.
Stategy Mapping Perspective: Enabler
Strategy Mapping Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Talent, Hiring, and Recruitment

Project/Initiative Title: 3. Hiring Plans

Purpose: Ensure that short and long-term hiring goals of the Service inform the recruitment and hiring activities.	**Desired Outcome:** Ensure that the Service is able to attract and hire candidates with the needed competencies in the required locations in a timely and cost-effective manner.

Description: IRS continues to place significant resource allocation toward the recruitment and hiring of talent from both internal and external sources. Short and long-term talent needs of the business and operating divisions are used to develop recruitment marketing and assessment strategies as well as resource needs. These needs also determine the resource requirements and work-plan strategies of the HCO employment offices.

Timeline/Milestones:

- Identify or develop a technology solution that will allow business and operating divisions to identify and document short and long term hiring needs in a manner that enables both data-driven recruitment strategy development and the allocation of resources to hiring office operations. (August 2006)
- Implement a planning and review process that ensures that short and long-term hiring needs are used to determine resource allocation and activities of the strategic recruitment and hiring office operations.

Goal 1: Continually Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission
Goal 2: Increase Employee Proficiency and Engagement
HCSP Strategy: Competency based infrastructure that integrates recruitment, selection, performance management, training, development, and career-pathing.
Stategy Mapping Perspective: Enabler
Strategy Mapping Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Talent, Hiring, and Recruitment

Project/Initiative Title: 4. Competency Infrastructure	
Purpose: Identify the knowledge, skills and abilities (competencies), necessary to meet the short term needs of the business and longer term needs of the Service.	**Desired Outcome:** An integrated competency based human resource system that assists in the recruitment and development of a competent and capable workforce that supports the needs of the business.

Description: Competency models identify the general and technical knowledge, skills and abilities essential to an employee's successful performance in a position. These models are used to identify the competencies needed at entry (recruitment and selection), developed on the job (training and development), measured in performance (performance management), and/or needed for future career planning (career pathing and succession planning).

Timeline/Milestones:

- Identify or develop a system/database from which other systems can access current competency models (July 2006)
- Implement a review process and/or review cycle to validate existing models and identify emerging trends/competencies (August 2006)

Goal 1: Continually Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission
HCSP Strategy: Develop and execute a robust workforce planning program with technological enhancements designed to identify workforce trends, gaps, and human capital needs across the Service.
Goal 2: Increase Employee Proficiency and Engagement to Enhance Tax Law Compliance
HCSIP Strategy: Continue to evaluate alternatives for employee learning and development and implement improvements to close critical competency gaps
Strategy Map Perspective: Enabler
Strategy Map Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Planning and Measures

Project/Initiative Title: 5. Strategic Workforce Plan

Purpose: To provide a comprehensive and coherent strategic workforce plan at a Servicewide level that is a useful tool.	**Desired Outcome:** A plan that facilitates getting the right people with the right skills, in the right place at the right time.

Description: The IRS Workforce Plan compares the current workforce profile with a five-year staffing forecast based on factors such as retirement, attrition, and hiring trends, including migration. Workforce composition is analyzed and macro level workload demand factors and their impact on workforce supply projections are presented. Major workforce gaps are identified and solutions are recommended along with action planning strategies.

Timeline/Milestones:
- Draft Workforce Plan January 2006
- Comparison Report of Workforce Planning Systems (final delivered) – January 2006
- Final Workforce Plan February 2006
- Upgrades and improvements to Integrated Workforce Planning System (IWPS) - September 2006

Goal 1: Continually Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission
HCSP Strategy: Leverage available technology for streamlined delivery of New Employee Orientation products.
Strategy Map Perspective: Enabler
Strategy Map Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Talent, Hiring & Retention

Project/Initiative Title: 6. New Employee Orientation Program

Purpose: Standardize and automate new employee orientation to provide current, more robust and consistent on-boarding.	**Desired Outcome:** A program that has identified requirements and needs for new employees and provides an efficient and consistent process for employment offices, business units, and managers.

Description: Standardize and automate new employee orientation to provide current, more robust and consistent on-boarding.

Timeline/Milestones:

- Final New Employee Orientation Script Guide for Employee Offices - December 2005
- Identify and consolidate all orientation information and tools under one New Employee Orientation Website – March 2006
- Corporate Guidance for Conducting New Employee Orientation for Employment Offices, Business Divisions, and Managers - April 2006
- Survey customers to ensure New Employee Orientation Program meets immediate needs (new employees, business units, and managers) – June 2006

Goal 2: Increase Employee Proficiency and Engagement to Enhance Tax Law Compliance
HCSP Strategy: Continue to evaluate alternatives for employee learning and development and implement improvements to close critical competency gaps.
Strategy Map Perspective: Enabler
Strategy Map Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Leadership and Education

Project/Initiative Title: 7. Level 3 Training Evaluation	
Purpose: The Evaluation Monitoring system (EMS) is a multi-level, progressive training evaluation model. It enables the education community to determine whether training imparts the knowledge and skills necessary for trainees to perform their jobs competently, and in so doing, help the Service accomplish its mission. The four levels comprising EMS are: trainee and instructor reaction (Level 1), trainee achievement (Level 2), trainee performance (Level 3), and organizational results (Level 4)	**Desired Outcome:** Employees in mission-critical occupations are fully proficient performing their job tasks as a consequence of training.

Description: Level 3 evaluation is a part-training survey of employees and their managers regarding the extent to which trainees, as a result of training, are fully proficient in performing their job tasks. Surveys are created online and administered via e-mail using Integrated Training Evaluation and Measurement Services (ITEMS) functionalities. Surveys may be based on individual courses or a series of courses (e.g., a curriculum).

Timeline/Milestones:
- Develop target for current year - March 2006
- Obtain L&E Policy Sub-council agreement on target for current year - July 2006
- Review results and establish target for next year - October 2006

Goal 1: Continually Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission **HCSP Strategy:** Succession Planning **Strategy Map Perspective:** Enabler **Strategy Map Objective:** Recruit, Train, Retain and Engage Employees **Project Owner:** Director, Leadership and Education	
Project/Initiative Title: 8. Strategic Leadership Succession Planning	
Purpose: Ensure replenishment of workforce needs for leadership populations.	**Desired Outcome:** A comprehensive corporate Leadership Succession Program.
Description: Completion of an assessment of current leadership programs, including the selection, assimilation and development processes; benchmark to best practices and alternate practices. Redesign of the current Executive readiness and development programs. Design and implementation of a process for talent identification and selection. Development of an "Assimilation" process for external candidates.	
Timeline/Milestones: Assessment: February to April 2006 Redesign of Executive programs: March to May 2006 Talent Identification: March to September 2006 Assimilation Process: May to December 2006	

Goal 2: Increase Employee Proficiency & Engagement to Enhance Tax law Compliance
HCSP Strategy: Leadership Development
Strategy Map Perspective: Enabler
Strategy Map Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Leadership & Education

Project/Initiative Title: 9. Leadership and Education Analysis Project (LEAP)

Purpose:	**Desired Outcome:**
To redesign the Learning and Education organization to best meet the mission of developing and delivering just-in-time, competency-based training.	A quality training organization that ensures efficient and effective operations.

Description:
The LEAP project is the result of an Office of Competitive Sourcing initiative regarding IRS training development and delivery. An executive decision was made to postpone an external A-76 competition and to develop an internal, streamlined training organization. The LEAP Team has spent over a year developing the redesigned organization, which was approved by the Human Capital Board on January 30, 2006.

Timeline/Milestones:
- IRS initiates public-private A-76 competition for Learning and Education services - February 2004
- Performance Work Statement developed; Decision to postpone A-76 & develop internal Most Efficient Organization (MEO) - May 2005
- LEAP Team developed the redesigned organization - 2005
- Redesign approval and implementation (planned) - 2006

Goal 2: Increase Employee Proficiency & Engagement to Enhance Tax Law Compliance
HCSP Strategy: Ensure that the IRS has leaders who effectively manager people by inspiring, motivating and guiding them toward mission goals while sustaining a learning environment that drives continuous improvement in performance.
Strategy Map Perspective: Enabler
Strategy Map Objective: Recruit, Train and Engage Employees & Leaders Who Engage Employees
Project Owner: Director, Resource Management

Project/Initiative Title: 10. IRS Employee Engagement Program

Purpose: Ensure Service wide consistent focus on employee engagement.	**Desired Outcome:** Increase participation and overall employee engagement

Description:
Servicewide program to improve organizational performance through the focus on balanced measures at the workgroup level. Workgroups will identify barriers to delivering the organization's goals and objectives as part of their ongoing operations. This process change will address many of the Q's that Gallup uses to determine employee engagement. Successfully administer Survey2006 to all IRS employees and provide each workgroup meaningful feedback data to successfully incorporate information gleaned from the Survey process into their normally scheduled workgroup meeting throughout the year to facilitate balanced measures approach to improve business results through achieving business goals.

Timeline/Milestones:
Select Vendor for 2006 Survey January- July 2006
Design, develop and implement Communications Plan w/C&L: January – July 2006
Administer Survey April-May 2006
Monitor and analyze information being entered into Engagment Tracker (ESTracker) July 2006
Analyze and provide top and bottom 10% data to each business unit
Issue Task order for Survey 2007 - August 2006
Select vendor for Survey 2007

Goal 2: Increase Employee Proficiency and Engagement to Enhance Tax Law Compliance
HCSP Strategy: Supports labor management relationship, institutional knowledge sharing and leadership development
Strategy Map Perspective: Enabler
Strategy Map Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Workforce Relations

Project/Initiative Title: 11. Employee Tax Compliance (ETC) Program

Purpose: To provide a comprehensive employee tax compliance program that proactively addresses employee noncompliance by focusing on educating employees regarding their tax obligations and identifying issues through cooperative arrangements with operating and functional divisions partners.

Desired Outcomes:
- Quick and agile management actions in key areas:
  - Agile communication and education based upon data-driven observation of employee compliance behaviors.
  - Proactive employee noncompliance detection
  - Higher employee compliance levels.

Description: Create a unified employee tax compliance program that incorporates communication and assistance, noncompliance detection and administrative adjudication.

Timeline/Milestones:
- Install IRS employee indicator on all data systems – April 2006
- Improve employee noncompliance detection procedures – December 2006
- Enhance the data support for the ETC process – May 2006
- Improve ETC administrative adjudication procedures – December 2006
- Enhance communications and educational outreach – Ongoing

Goal 1: Continuously Assess and Shape the Workforce to Efficiently Accomplish the Service's Mission
HCSP Strategy: Diverse workforce that possesses the knowledge, skills and abilities, competencies, necessary to meet both the short term needs of the business and the longer term workforce goals of the Service.
Strategy Map Perspective: Enabler
Strategy Map Objective: Recruit, Train, Retain and Engage Employees
Project Owner: Director, Talent, Hiring and Recruitment

Project/Initiative Title: 12. Targeted Recruitment (Diverse Workforce)

Purpose: To ensure the Service employs a diverse workforce that is able to deliver the program goals of the business.	**Desired Outcome:** To attract and retain a diverse workforce with the right competencies, in the right positions, at the right time, and to ensure the goals of the organization are achieved in a timely manner.

Description: A multi-year recruitment and marketing plan is used to target a diverse applicant pool. This is coupled with a comprehensive assessment strategy to identify applicants with the knowledge, skills, and abilities (competencies) necessary to meet the needs of the business.

Timeline/Milestones:

- Establish a baseline list of hiring initiatives for FY 2006 - February 2006
- Deploy a recruitment and marketing strategy for FY 2006 targeting diversity and the technical skills needed to achieve the mission critical hiring initiatives - December - August 2006
- Establish a goal to assess the success of the strategy in achieving a sufficient applicant pool - March 2006

Goal 2: Increase Employee Proficiency & Engagement to Enhance Tax Compliance
HCSP Strategy: Ensure that the IRS has leaders who effectively manage people by inspiring, motiviating and guiding them toward mission goals while sustaining a learning environment that drives continuous improvement in performance.
Strategy Map Perspective: Enabler
Strategy Map Objective: Leverage IRS Relationships
Project Owner: Director, Workforce Retention and Transition

Project/Initiative Title: 13. National Work Schedule (NWS) Agreement

Purpose: Implement a consistent business wide approach to offering work schedules throughout IRS. Eliminate outdated local Alternate Work Schedule (AWS) agreements to ensure consistent application and opportunity for employees.	**Desired Outcome:** A consistent Service-wide application of rules and regulations as it applies to the administration of hours of work and alternate work schedules.

Description: Implement a consistent business wide approach to offering work schedules throughout IRS. Eliminate outdated local AWS agreements to ensure consistent application and opportunity for employees.

Timeline/Milestones:
- Implementation of Mid-term Agreement - January 2006
- Identification of BOD NWS options within mission requirements – April 2006
- IRS / NTEU NWS "discussions" completed - April 2006
- Term negotiations - June 2006

Goal 4: Enable Quick and Agile Management Action to Achieve Business Goals
HCSP Strategy: Establish labor management relations platform that leverages relationship with NTEU and advances management interests including change initiatives.
Strategy Map Perspective: Enabler
Strategy Map Objective: Leverage IRS Relationships
Project Owner: Director, Workforce Relations

Project/Initiative Title: 14. Labor/Management Relations Committees (LMRCs)

Purpose: The LMRC will provide an opportunity for management and NTEU to raise issues for discussion prior to requesting formal negotiations in the broad areas of personnel policies, practices, and working conditions that may have national, cross-functional, or local impact on employees.	**Desired Outcome:** Improve the working relationship with NTEU, foster trust, and gain a greater understanding of each others' concerns. Management officials should expect to receive valuable, pre-decisional information from NTEU representatives for consideration in their decision-making process. NTEU should expect to have their concerns and opinions sought and considered by management officials in their deliberative processes. LMRC discussions should enhance the bargaining process as the parties have a greater understanding of the initiatives and the objectives sought in implementation.

Description: The National LMRC will serve as a forum for pre-decisional input and discussion on matters of concern or interest in personnel policies, practices, and working conditions that may have national, cross-functional or local impact on employees. Additionally, the council will be responsible for National Diversity and Equal Employment Opportunity and Health and Safety issues.

Local LMRC's will focus on the issues within their geographic Senior Commissioner Representative (SCR) area, whether it involves just one division/function or all divisions/functions in that SCR area.

Timeline/Milestones:
- Establish all LMRC's – FY 2006
- Others to be determined

Goal 4: Enable Quick and Agile Management Action to Achieve Business Goals
HCSP Strategy: Implement a collective bargaining agreement that provides maximum flexibility to accomplish the Service's mission in an efficient manner.
Strategy Map Perspective: Enabler
Strategy Map Objective: Leverage IRS Relationships
Project Owner: Director, Workforce Relations

Project/Initiative Title: 15. Term Bargaining

Purpose: To negotiate a successor service-wide agreement that replaces the National Agreement.	**Desired Outcome:** Implement an agreement that provides maximum flexibility to achieve business results in an efficient manner.

Description:
Term bargaining will provide a successor National IRS / NTEU collective bargaining agreement

Timeline/Milestones:

Currently under discussion

Goal 3: Leverage Human Capital Technology to Reduce Burden
HCSP Strategy: Continue to evaluate alternatives for employee learning and development. Implement improvements to close critical competency gaps.
Strategy Map Perspective: Enabler
Strategy Map Objective: Enable IRS Strategy through Technology
Project Owner: Director, Leadership and Education

Project/Initiative Title: 16. Enterprise Learning Management System (ELMS)

Purpose:	**Desired Outcome:**
To improve training effectiveness by providing just-in-time and increased access to information, tools, and training, to improve training efficiency by decreasing the direct time people are engaged in training and reducing training delivery and travel costs, and to improve organization operations by retiring outdated and redundant learning systems	A learning system that allows for the efficient and effective development and delivery of e-training.

Description:
The IRS Enterprise Learning Management System (ELMS) is the e-Learning system architecture that allows the Agency to transition from a classroom-based to a technology-enabled learning and performance-support environment. It is a web-based application that employees, managers, and the learning and education community use to manage training and development. ELMS consists of two commercial off-the-shelf (COTS) components, a Learning Management System (LMS) to administer training and a Learning Content Management System (LCMS) to provide a structured environment to develop, store, maintain, and reuse content. ELMS will be integrated with other IRS applications (virtual conferencing, room scheduling, etc.) and Treasury systems (HR Connect, Career Connector, etc.) to provide comprehensive training support. IRS is a partner with the OPM government-wide e-training initiative (Go Learn), which provides secure hosting facilities for ELMS.

Timeline/Milestones:
- The LMS component of ELMS is deployed Servicewide - January 2005
- The LCMS component of ELMS is deployed to the IRS education community - December 2005
- LMS software upgrade - April 2006
- System hardware upgrade - June 2006
- Integration with the Centra video conferencing application - July 2006

Goal 3: Leverage Human Capital Technology to Reduce Burden
HCSP Strategy: Embrace programs and tools that share institutional knowledge and use innovative means to link knowledge across business units to facilitate best practices, promote personal and professional growth, and avoid failures.
HCSIP Strategy: Establish a clear vision and strategy that will move us to a virtual workforce, where we can move work around electronically without regard to the location of workers, and where workers are able to set up virtual offices in a non-traditional office setting.
Strategy Map Perspective: Enabler
Strategy Map Objective: Enable IRS Strategy through Technology
Project Owner: Director, Talent, Hiring and Recruitment

Project/Initiative Title: 17. *CareerConnector*

Purpose: To provide an automated recruitment tool for the Department. Note that *CareerConnector* is Treasury's enterprise system for internal and external recruitment under the HR Connect Umbrella.	**Desired Outcome:** Delivery of a standard automated tool for internal and external recruitment resulting in improved performance and time and cost savings associated with streamlined processes that capitalize on system capabilities.

Description: *CareerConnector* is an applicant management system that provides an online job application (including resume) and automated rating, ranking, and referral of applicants for job consideration and selection. System has the flexibility to support the variety of recruitment processes used by the IRS to fill its positions under merit promotion (includes internal processes used for management selection, executive selection, and BU/NBU selection) and the competitive processes used for external recruitment.

Timeline/Milestones:
- Expand the system to include internal recruitment - 2006
- Completed conversion to release of Phase 6 - December 2006
- Initiated use for filing season recruitment - August 2005
- Established content development and deployment team- February 2005
- Added occupations (included limited Campus Pilot) - 2004-2005

Goal 3: Leverage Human Capital Technology to Reduce Burden
HCSP Strategy: Leadership recruitment and retention; succession planning
Strategy Map Perspective: Enabler
Strategy Map Objective: Enable IRS Strategy through Technology
Project Owner: Director, Executive Services

Project/Initiative Title: 18. Succession Planning Resource Center

Purpose: To enhance and expand the Succession Planning Resource Center designed for use by the IRS with three main objectives:

- To enable executive positions to be filled quickly and with the best qualified candidates;
- To determine organizational GAPS for future targeted recruitment; and
- To prompt the organization to determine training and development needs for an executive.

Desired Outcome: The Succession Planning Resource Center was created as a deliberate and systemic strategy and process for ensuring leadership continuity within the Internal Revenue Service. It allows candidates the opportunity to indicate positions of future interest, thus enabling the IRS to fill its executive positions quickly and with the best qualified candidates. As these changes take place, it is critical to Service's mission to ensure stability in the executive levels of the organization, as well as to enhance the SPRC to permit a unified data source for managers at all levels.

Description: A centralized repository of succession planning information from front-line managers through executives. Though currently limited to executives, the Succession Planning Resource Center will be expanded as part of the Strategic Leadership Succession Planning Project.

Timeline/Milestones:

- Expanded Succession Planning Resource Center designed and operational - December 2006

Goal 3: Leverage Human Capital Technology to Reduce Burden
HCSP Strategy: Develop and implement a Workforce Planning System designed to identify and assess workforce trends, gaps, and human capital needs across the Service and which provides appropriate resolution identification, implementation planning and evaluation of resolution(s).
Strategy Map Perspective: Enabler
Strategy Map Objective: Enable IRS Strategy through Technology
Project Owner: Director, Planning and Measures

Project/Initiative Title: 19. Workforce Analysis Suite

Purpose: To enable a comprehensive and coherent strategic workforce planning system based upon technology driven systems which provide appropriate data, methodologies, and analysis, and which offer staffing projections out to five years, define present and forecast future workforce supply and demand, and present a systematic approach for determining and evaluating workforce resolutions.	**Desired Outcome:** A robust set of workforce analytical tools capable of delivering timely and accurate workforce data necessary to inform management decisions and support the development and implementation of the workforceplanning system.

Description: Technology driven analysis of workforce data elements, including migration analysis, attrition and retirement projections designed to inform management and offer input to business decisions.

Timeline/Milestones:
- Comparison Report of Workforce Planning Systems (final version)– January 2006
- Recommend options for modifying/enhancing IWPS and eHRI – Enhancement Report Deliverable- May 2006
- Identify and assess the feasibility/desirability of alternative forecasting systems including HCAS – (enhancements briefing deliverable) - July 2006
- Roll out of necessary upgrades and improvements to IWPS, HCAS and required "alternative" systems- September 2006
- Servicewide Strategic Workforce Plan reviewed, refined and revised – December 2006
- Draft updated Strategic Workforce Plan released for comment - January 2007
- Updated Strategic Workforce Plan finalized and issued -February 2007
- Assess the comparative costs/benefits of IWPS and HCAS and address issues of redundancy and value of additional system upgrades – (final determination) - September 2007
- eHRI tested, evaluated and implemented within IRS – September 2007
- eHRI operational within IRS with requisite complementary IRS specific systems – March 2008

Goal 3: Leverage Human Capital Technology to Reduce Buren
HCSP Strategy: To work in support of hiring, training/development and other HR processes
Strategy Map Perspective: Enabler
Strategy Map Objective: Enable IRS Strategy through Technology
Project Owner: Director, Talent, Hiring and Recruitment

Project/Initiative Title: 20. Competency Assessment Center

Purpose: Develop and deploy competency- based assessments via an on-line assessment center.	**Desired Outcome:** To leverage technology, ensure consistency, and reduce employee and manager burden in the delivery of competency based assessments.

Description: Competency Assessment Center is a web-based intranet portal whereby the business can deploy general and/or technical assessments in support of internal hiring, training/development, and/or certification processes. Employees and their managers receive immediate feedback on the results of the assessment via email. The Center is currently piloting the Field Assistance Technical Assessment Battery.

Timeline/Milestones:

- Deploy the competency based technical accounting assessments used in hiring for the Tax Specialist, Tax Compliance Officer, and Tax Resolution Representative positions (September 2006).
- Deploy other future competency based hiring and/or training/development assessments in support of the CareerConnector and ELMS implementation.

System of Accountability

The success envisioned in this Human Capital Strategic Implementation Plan is dependent on effective management of many projects, all representing change, some including the deployment of new technology, and some requiring the establishment of new cultural norms. A strong, disciplined system of accountability is required to identify those that may need additional monitoring, support, resources, or adjustments to ensure their success.

- The Commissioner of Internal Revenue has delegated to the Deputy Commissioner for Operations Support direct accountability for the Plan's implementation.
- The IRS Oversight Board, through its Operations Support Committee, will continue to provide counsel.
- The Human Capital Board, as principle steward of the Human Capital Strategic Plan, has primary governance of and oversight over the implementation plan.
- The Chief Human Capital Officer and Deputy Chief Human Capital Officer will have performance commitments that ensure a direct link between plan performance and individual accountability. Similar commitments will be expressly stated for project owners.
- The Strategy Mapping Teams will also be responsible for validating and assessing the objectives, weights, and core processes annually to ensure the assumptions underlying the plan remain current.

In this manner, the focus of the Implementation Plan will remain current and on course.

Measuring our Performance

Upon approval of this plan, the Chief Human Capital Officer shall institute quarterly Business Performance Review (BPR) reporting of the individual projects and indicators contained in the HCSIP. This portion of the HCSIP will be updated annually to reflect new targets.

IRS HUMAN CAPITAL STRATEGIC PLAN IMPLEMENTATION MEASURES

Core Process	Metrics	FY 2005 Baseline	FY 2006 Target
Hiring & Recruitment			
	• Percentage of business units receiving workforce planning updates quarterly	new	100% (eff. Q2)
	• MCO external vacancy hiring time: % meeting 45 work day target for job offer	90%	90%
	• Percentage of full time permanent employees in MCO positions to the total number of IRS employees in full time permanent positions	62.4%	tbd
	• Percentage of MCO hiring plans timely met	95%	95%
	• Percentage of hiring initiatives for which targeted outreach is conducted	tbd	+10%
	• Increased educational/experience level of MCO new hires	new	tbd
	• Percentage of significant modernization projects where human capital impact is documented	new	100%
	• EEO diversity measure (will adapt to EEO corporate measure)	new	tbd
	• Customer satisfaction with *CareerConnector* hiring	85%	85%
	• Customer dissatisfaction with *CareerConnector* hiring	05%	05%

Core Process	Metrics	FY 2005 Baseline	FY 2006 Target
	• Percentage of frontline managers receiving timely frontline leadership development training.	84%	95%
	• Overall quality of frontline leadership development courses	4.73	4.75
	• Overall quality of frontline leadership development course instructors	4.83	4.86
	• Overall quality of senior manager readiness program	4.91	4.94
	• Percentage of managers offered timely access to leadership support training	new	+5%
	• Percentage of managers who timely complete required leadership development training	new	+5%
	• Percentage of training courses assessed using level III	.7%	1%

IRS HUMAN CAPITAL STRATEGIC PLAN IMPLEMENTATION MEASURES

Core Process	Metrics	FY 2005 Baseline	FY 2006 Target
Employee Development	• Percentage of MCOs receiving continuing professional education	95%	95%
	• Percentage of full-time permanent employees in MCOs at or above full working level compared to all full time permanent employees in MCOs	87%	tbd
	• Percentage of MCO positions for which assessment tools have been developed	75%	90%
	• Number of MCO positions for which assessments are used to determine existing workforce competencies	new	2
	• Number of assessed MCO positions for which plans are implemented to close competency gaps in existing workforce	new	1
	• IRS-wide score: Receive training needed for effective job performance (Q13)	3.62	3.65
	• IRS-wide score: Someone has talked to me about my progress in the last six months. (Q11)	4.0	4.0
Labor Relations	• Number of LMRCs established in accordance with the National Mid-term Agreement	0	38
	• Percentage of issues resolved informally by national representatives pursuant to Article 46, Section 4.	new	tbd

IRS HUMAN CAPITAL STRATEGIC PLAN IMPLEMENTATION MEASURES

Core Process	Metrics	FY 2005 Baseline	FY 2006 Target
Employee Engagement	• IRS-wide employee engagement score (grand mean)	3.80	3.85
	• IRS-wide score: Know what is expected of me at work (Q1)	4.20	4.23
	• IRS-wide score: My opinion counts (Q7)	3.46	3.48
	• IRS-wide score: IRS mission makes me feel my job is important (Q8)	3.71	3.74
	• IRS-wide score: Believe my co-workers are committed to doing quality work (Q9)	3.97	3.98
	• IRS-wide score: Have had opportunities to learn and grow (Q12)	3.81	3.83
HR Technology	• Percentage of MCOs deployed on-line via *CareerConnector*	50%	85%
	• Percentage of MCO training classes available on-line	new 62%	tbd 80%
	• Percentage of employees able to use HR technology to manage their careers	62%	90%
	• Percentage of managers able to use HR technology to manage the workforce (e.g., ELMS, HR Connect, SETR and ERC)	50%	85%
	• Percentage of HR professionals able to use HR technology to improve service to customers		

Closing

This living document, replenished every two years, will ensure the alignment of human capital strategies to the IRS' strategic plan. It is with pleasure that we present it on behalf of the IRS' human capital community, successfully "Linking Human Achievement with Business Results."

Beverly Ortega Babers
Chief Human Capital Officer
Internal Revenue Service

Written Statement of
Nina E. Olson
National Taxpayer Advocate

Before the

Subcommittee on Taxation and IRS Oversight

Committee on Finance
United States Senate

Hearing on

The Tax Gap

July 26, 2006

Mr. Chairman, Senator Jeffords, and distinguished Members of the Subcommittee:

Thank you for inviting me to testify today regarding the causes of the tax gap and possible legislative and administrative solutions.[1]

At the outset, let me suggest that the ultimate question we should be focused on is not "How can we reduce the tax gap?" but rather "How can we increase voluntary compliance?" Voluntary compliance – as opposed to enforced compliance – must be our goal for several overriding reasons.

- First, enforcement is best suited for circumstances in which taxpayers are willfully seeking to evade their tax obligations. As I will describe in more detail below, the limited data available suggests that a high percentage of taxpayer errors – probably a significant majority – are attributable to inadvertence rather than deliberate cheating.

- Second, it is far preferable from a public policy standpoint when taxpayers pay voluntarily rather than pursuant to enforcement action. We should strive to make sure taxpayers understand how the tax dollars they pay are used to protect and benefit them, and we should make compliance as easy as possible.

- Third, the IRS lacks the resources to do much more through enforcement. The examination rate is currently less than one percent, and the majority of those examinations are limited-scope examinations conducted by mail.[2] Even if we were somehow able to double the examination rate, more than 98 percent of taxpayers would not be examined each year. So we need to focus on maximizing voluntary compliance by simplifying the tax laws and improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear abuses and send a message to all taxpayers that noncompliance has consequences.

- Fourth, we need to identify ways to slowly transform attitudes toward the tax system to create new norms of behavior – namely, tax compliance. Enforcement is only moderately successful at that, and it is generally not very successful with taxpayers who erred inadvertently. In fact, harsh enforcement measures against inadvertently noncompliant taxpayers may increase distrust of the IRS and create deliberate noncompliance.

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[1] The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. The statute establishing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

[2] 2005 IRS Data Book, Table 10, at 19. The IRS also proposes adjustments using math-error authority and its automated under-reporter (AUR) and automated substitute for return (ASFR) programs.

I. The Tax Gap Is A Significant Problem From The Perspective Of Both Federal Revenue And Taxpayer Equity.

The Federal tax gap has been receiving increasing attention over the last few years. It deserves this increased attention and more. The recent IRS National Research Program study estimates the 2001 "gross tax gap" – the difference between the amount of tax imposed by law and the amount of tax paid voluntarily and timely – at $345 billion. It estimates the net tax gap – the difference between the amount of tax imposed by law and the amount of tax paid after taking into account late payments and enforced collection – at $290 billion. In fact, the IRS acknowledges the actual tax gap is larger. For example, the study did not even venture a guess as to the amount of illegal source income that goes unreported and on which taxes are not paid.

If the IRS were able to collect all taxes due under current law, we would not have a budget deficit. If the IRS were able to collect half the taxes that currently go uncollected, we could repeal the Alternative Minimum Tax. Of course, it will never be possible to eliminate the tax gap entirely, but even modest improvements have significant revenue implications.

In addition to these larger issues, I want to emphasize that the tax gap has real victims. Individuals and businesses that fail to pay their taxes impose a significant burden on taxpayers who comply with their tax obligations. If we divide the 2001 net tax gap estimate of $290 billion by the roughly 130 million individual tax returns received, we can see that each tax filer in 2001 paid, on average, a "surtax" of more than $2,000 to subsidize noncompliance by others.

As the National Taxpayer Advocate – the statutorily designated advocate for *all* taxpayers as well as specific taxpayers – I am concerned about the economic and social costs that this noncompliance imposes. In my 2003 Annual Report to Congress, I identified the tax gap, after the AMT, as the most serious problem facing taxpayers. I have continued to address the tax gap in my more recent reports to Congress, and I have testified before Senate committees on the subject on four previous occasions.[3]

II. Reasons for Noncompliance Vary Among Taxpayers and Proposals to Increase Compliance Should Be Devised Accordingly: "One Size Fits All" Won't Work.

To arrive at an optimal allocation of resources to close the tax gap, the IRS needs to do a better job of understanding the reasons why the tax gap exists. As I will describe in more detail below, I am concerned that the IRS has made a decision, without adequate basis, to emphasize enforcement over improved taxpayer service.

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[3] The National Taxpayer Advocate has testified at the following Senate hearings focused on the federal tax gap: Senate Budget Committee (February 15, 2006); Senate Homeland Security and Governmental Affairs' Subcommittee on Federal Financial Management, Government Information, and International Security (Oct. 26, 2005) (written statement only); Senate Finance Committee (April 14, 2005); Senate Finance Committee (July 21, 2004).

I also believe that there are limits to what the IRS can do on its own. Any improvements IRS is able to make in collecting tax revenue will be limited unless Congress simplifies the tax code and increases third-party information reporting or withholding to cover a wider array of financial transactions.

A. Types Of Noncompliance Vary.

At the risk of oversimplifying matters, let me suggest that we consider 3 types of taxpayers: (1) taxpayers who will go to great lengths to comply with whatever requirements exist; (2) taxpayers who view taxes as one of many burdens they face in everyday life and who will comply if doing so is straightforward and not time-consuming; and (3) taxpayers who willfully seek to evade their tax obligations.[4]

For each type of taxpayer, what is the reason for noncompliance and what is the optimal government response?

- For taxpayers who generally will go to great lengths to comply, the likely source of noncompliance is the complexity of the tax code. Thus, our approach should be to emphasize simpler laws and better explanations.

- For taxpayers who will comply if doing so is easy enough, our main emphasis should also be simpler laws and procedures, and better outreach and education. Here, though, we might also want to incorporate gentle enforcement action in our approach to try to persuade taxpayers that paying taxes must be a higher priority. In doing so, the IRS should incorporate taxpayer service *within* its enforcement actions. That is, at the same time that the IRS conducts audits or seeks to collect unpaid tax liabilities, the IRS should be courteous and should focus on trying to teach taxpayers how to avoid getting into trouble in the future. The IRS also must be careful to avoid creating noncompliance by imposing unrealistic procedural burdens on taxpayers who are trying to comply.

- For taxpayers who willfully seek to avoid paying taxes, enforcement is required – although even for these taxpayers, I think IRS employees generally should focus on trying to induce the taxpayers to comply prospectively.

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[4] Analysis has been conducted on types of noncompliance that is more detailed and subdivides taxpayers into narrower categories. *See* Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All,* 51 U. Kan. L. Rev. 1145 (2003).

B. A Substantial Amount of Misreporting – Probably the Majority of All Misreporting Errors – Is Attributable to Inadvertent Error Rather Than Intentional Noncompliance.

What percentage of taxpayers fall into each of the three categories I just described? It is impossible to know with precision. But I will briefly describe two sources of information that lead me to believe the majority of taxpayer errors are attributable to inadvertent error rather than intentional noncompliance. And this conclusion implies that the second category of taxpayer I described – the taxpayer who is not especially sophisticated and will try to comply if doing so is not overly burdensome – is where we should be directing most of our attention.

When IRS auditors conducted approximately 46,000 audits of individual taxpayers for purposes of the National Research Program, the auditors were asked, for each issue they identified, to characterize the reason for noncompliance. As shown in the following chart, the results were striking:

Reason Category	Total Issues	Percent of All Issues	Percent of All Issues Excl No Change
Inadvertent/Mistake	164,780	31%	67%
Automatic/Computational	66,907	12%	27%
Deliberate/Intentional	7,542	1%	3%
No Show/Audit Recon/SFR	4,962	1%	2%
No Change	289,096	54%	N/A
EITC Adjustment	1,401	0%	1%
Classification Issue	13	0%	0%
No Reason Code Entered	1,784	0%	1%
All Issues	536,485	100%	100%

Among issues that IRS auditors examined that resulted in a change in tax liability, the auditors listed 67 percent as inadvertent mistakes, 27 percent as computational errors or errors that flowed automatically, and only 3 percent of errors as intentional.[5]

A recent study of capital gains misreporting conducted by the Government Accountability Office also makes the case that a substantial percentage of noncompliance is inadvertent. The study concluded that 33 percent of taxpayers who misreported their income from securities transactions reported more capital gains than they actually realized.[6] Taxpayers who over-report their income (and thus generally pay more taxes than they owe) clearly are not trying to cheat. Where misreporting is inadvertent, from a statistical standpoint, one would expect that 50 percent of errors would be on the high side and 50 percent of errors would be on the low side. Thus, GAO's finding that 33 percent of all taxpayer errors were on the high side (and thus clearly inadvertent) implies that an equal percentage of errors on the low side were inadvertent – or, put differently, that 66 percent of all errors in capital gains misreporting were inadvertent and only 34 percent were intentional.

One might argue that inadvertent errors should not be considered in discussing the tax gap because inadvertent errors should theoretically offset each other in their impact on revenue, leaving intentional errors alone as the source of the tax gap. I would fundamentally disagree with such an assessment for at least three reasons. First, the mission of the IRS is to collect the *proper* amount of tax due – not to collect as much as it can get away with.[7] The IRS therefore has an equal duty to address errors of overpayment and errors of underpayment. If the IRS is perceived as lacking revenue neutrality in carrying out its mission to collect the proper amount of tax due, the negative impact on the public's perception of the fairness of government would be hard to overstate.

Second, I do not believe that benign noncompliance is revenue neutral. For example, considerable noncompliance involves taxpayers who do not file any returns at all – not primarily because they are trying to cheat but because they find the requirements

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[5] The precision of these results may be open to question, but even accounting for a significant margin of error, the designation by IRS's own auditors of only 3 percent of identified misreporting issues as intentional raises fundamental questions about the wisdom of the IRS's current objective of ramping up enforcement activities more than outreach and education. In the absence of contrary data, these data at a minimum should persuade IRS to conduct significant new studies on the causes of noncompliance. Largely in response to the Administration's budget request, the Senate Appropriations Committee last week recommended an IRS budget for FY 2007 that includes $4.8 billion for enforcement and $2.1 billion for taxpayer service. If the percentage of taxpayer errors resulting from intentional noncompliance is anything close to 3 percent, the balance between enforcement and taxpayer service should be fundamentally reevaluated in future years.

[6] Government Accountability Office, Ref. No. GAO-06-603, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed* at 12 (June 2006).

[7] The official IRS mission statement commits the IRS to "[p]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." *See* IRS News Release IR-98-59 (Sept. 24, 1998).

difficult to understand and are trying to avoid the burden. This may be particularly true for relatively low income taxpayers, taxpayers who speak English as a second language, and small business taxpayers.

Third, the large number of inadvertent errors underscores the need to go beyond classifying taxpayers simplistically as "honest" or "dishonest" and to develop solutions designed to improve compliance among a broader range of taxpayers through an approach that includes components of both taxpayer service and enforcement.

III. The IRS Can Do More To Improve Compliance Under Existing Laws.

A. The IRS Should Conduct More and Better Research On How To Get the Most Impact from Each Dollar Spent.

The IRS needs better research to determine the most effective use of its resources after taking into account both the direct and indirect effects of its activities on tax revenue.[8] In most cases, the indirect effects are probably greater than the direct effects. Assume, for example, that the IRS increases the rate at which it audits a cash-based industry like construction and conducts the audits effectively so that it discovers all unreported income. The indirect revenue gains resulting from these audits would probably exceed the direct gains by a large margin as word spreads throughout the industry that cash income is actually subject to tax and each industry participant realizes that the IRS is examining taxpayers just like him or her. IRS researchers have estimated that the indirect effect of an average examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment.[9]

However, not all audits have the same effect on compliance. A dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing corporate tax shelters. A dollar spent on an ineffective audit may actually have a negative effect on compliance if it teaches taxpayers that they will not be caught even if audited. On the other hand, a dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving the Electronic Funds Transfer Payment System (discussed below), and answering tax law questions, has a positive indirect effect on compliance.[10]

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[8] *See generally* Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005).

[9] Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax*, 1977-1986, 43 Nat. Tax J. 395, 396, 405 (1990).

[10] In 1996, IRS researchers estimated that every dollar the IRS spent on return preparation generated $396 of additional tax revenue. *See* Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996).

The IRS does not have current research to show where its next dollar is best spent. More generally, we do not even know whether the next dollar is better spent on enforcement or on taxpayer service.[11] In the absence of better research, decisions about how to allocate IRS resources are being based largely on hunches and slightly educated guesses.[12]

B. It Shouldn't Be a Question of "Service or Enforcement": The IRS Should Integrate Taxpayer Service within Its Enforcement Activities.

Particularly in light of its limited resources, it is critical that the IRS focus its enforcement activities not merely on collecting taxes that were not paid in the past but on trying to bring taxpayers into compliance prospectively. At present, I am concerned that the IRS is approaching its taxpayer service and enforcement initiatives on almost entirely separate tracks. That is, in the IRS today, enforcement employees work on enforcement initiatives, and taxpayer service employees work on taxpayer service initiatives, and never the twain shall meet. This "stovepipe" approach is evidenced most clearly by the fact that the Taxpayer Assistance Blueprint (the TAB) the IRS is preparing pursuant to an Appropriations directive focuses almost entirely on the taxpayer service needs of individuals who earn wages and investment income – despite the fact that the largest segment of the tax gap is attributable to self-employed taxpayers.

As I discussed above, I believe strongly that the goal of a fair and just tax system must be to do everything possible to promote voluntary compliance. This is so, because *voluntary* compliance – as opposed to *enforced* compliance – creates taxpayers who are willing to work with the tax system rather than taxpayers who hide from the tax system. Moreover, in the long run, *voluntary* compliance is the most cost-effective way to achieve lasting compliance.

Both IRS enforcement and service personnel must listen with a keen ear to what each taxpayer is saying to see if there is an opportunity to educate the taxpayer about how to avoid repeating a problem, even as we rectify the current one. If we approach taxpayers as if they are guilty, if we assume that the only explanation for their behavior is intentional noncompliance, if we look at a collection case or an examination not as an

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[11] For a more detailed discussion, *see* National Taxpayer Advocate 2004 Annual Report to Congress 211-225 (Most Serious Problem: IRS Examination Strategy); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Committee on Finance on The Tax Gap (Apr. 14, 2005); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, The Judiciary, Housing And Urban Development, and Related Agencies (Apr. 7, 2005); *see also* Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005); Treasury Inspector General for Tax Administration, Ref. No. 2005-10-159, *A Better Model Is Needed to Project the Return on Additional Investments in Tax Enforcement* (Sept. 2005).

[12] The Government Accountability Office has also recommended that the IRS obtain more and better research regarding the reasons that taxpayers fail to comply with the law. *See, e.g.*, Government Accountability Office, GAO-06-208T, *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-term Goals Are Needed to Improve Taxpayer Compliance* (Oct. 26, 2005).

interaction between a taxpayer and his government but instead as just another case that needs to be closed within a set cycle time – well, we most assuredly will get the behavior from the taxpayer that we expected to see. The reality is that neither is it good for the government and its citizens to be in conflict with each other more than necessary nor do we have the resources to collect our taxes primarily through enforcement actions. That is why achieving a high rate of voluntary compliance is not merely desirable but essential.

Two examples are worth noting:

Federal Payment Levy Program. The FPLP is an automated levy program that systemically matches IRS records against those of the Financial Management Service (FMS) to locate federal payment recipients who have delinquent tax debts. The IRS is authorized to issue continuous levies for up to fifteen percent of federal payments to taxpayers with delinquent tax debts.[13] As we noted in the National Taxpayer Advocate's 2005 Annual Report to Congress, 84 percent of all FPLP levies over the past four years were issued against Social Security income.[14] When considering that Social Security benefits provide a safety net and may be the sole source of income for many low income taxpayers, the IRS's lack of a screening mechanism to differentiate among taxpayers when imposing FPLP levies is a serious problem. The IRS previously employed such a filter, known as "total positive income" (TPI).[15] In June 2005, however, the Government Accountability Office (GAO) concluded that the TPI was "an inaccurate indicator of a taxpayer's ability to pay."[16] Soon thereafter, the IRS ceased using the TPI as a means to predict hardship status and has not developed a replacement indicator.

TAS has recently reached agreement with the IRS Wage & Investment Division to form a joint task force to further explore the FPLP process as a whole and better address the need for an income filter (or similar mechanism) to minimize the potential for hardship to taxpayers. But an agency charged with serving the needs of the American people should never have allowed procedures to continue for so long that withhold benefit payments without regard to need. This does little to build confidence in the fairness of government.

TAS Relief Rate in Automated Under-reporter (AUR) Cases. The IRS matches return information against wage and other information reporting documents it receives from third parties. Where there is a disparity, the AUR program may automatically

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[13] The Federal Payment Levy Program is authorized by IRC § 6331(h).

[14] National Taxpayer Advocate 2005 Annual Report to Congress 124-130

[15] TPI was based on information taken from the taxpayer's last filed tax return and was calculated by summing the positive values from the following fields: wages; interest; dividends; distributions from partnerships, small business corporations, estates or trusts; Schedule C net profits; Schedule F profits; and other income such as Schedule D profits and capital gain distributions. General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures, Performance and Equity Can Be Improved* 11 (March 6, 2003).

[16] General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures, Performance and Equity Can Be Improved* 11 (March 6, 2003).

generate a notice to the taxpayer. But the AUR program is far from infallible. In fact, among all AUR cases closed by the Taxpayer Advocate Service during the first 9 months of FY 2006, the taxpayer ultimately received full or partial relief in 74 percent of our cases.[17] Particularly as the IRS increasingly automates its enforcement activities, enforcement cannot be simply about flipping on a switch. The IRS must do a better job of monitoring the accuracy of its enforcement programs to ensure that they are well targeted. Where a software program misfires, it is critical that the IRS provide first-rate service to regain the trust of the taxpayers on whom the IRS imposed an unnecessary burden.

C. To Effectively Address the Cash Economy Tax Gap, the IRS Should Initiate a Local Compliance Strategy and Utilize Local and State Data.

Because tax compliance trends and norms are frequently local, it will be difficult for the IRS to develop successful initiatives without local feedback about how its strategies are affecting taxpayers in a given community. The IRS needs such information so that it can adjust its strategy to effectively address local compliance issues. The IRS previously recognized the importance of a local response when it created local Compliance Planning Councils in the mid-1990s and gave them the authority to allocate local compliance resources and research.[18]

If the IRS could focus its enforcement and educational efforts on a particular local market, it might be able to change norms of behavior within that market. A local planning organization could work to identify local compliance challenges, direct the IRS's local response, and measure its effectiveness. A national cash economy program office could replicate successful local strategies nationwide.

Moreover, the IRS should use more of the information available from state and local governments, Forms 8300 (Report of Cash Payments Over $10,000 Received In a Trade or Business), and its audit selection tools to audit taxpayers who are operating in the cash economy and underreporting their income. Although the IRS has access to state and local tax information, reporting on large cash transactions, and computer-based tools to identify underreporting, it used very few of these resources in FY 2005.[19]

Many states and localities impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts.[20] The IRS should consider

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[17] Taxpayer Advocate Management Information System (TAMIS) data (FY 2006 through June 30, 2006).

[18] *See* General Accounting Office, GAO/GGD-96-109, *Tax Research: IRS Has Made Progress but Major Challenges Remain* 30 (June 1996); Internal Revenue Service, District Office of Research and Analysis (DORA), *Phase I Training Material: IV. Framework; NORA, DORA roles*, 8.

[19] In FY 2005, the IRS considered 1,092 state information items for examination potential, reviewed 2,366 Forms 8300, and closed 15,873 examinations of non-EITC taxpayers filing Schedules C selected using its Unreported Income Discriminant Function (UI-DIF).

[20] *See, e.g.*, Fairfax County Code §§ 4-7.2-1 through 4-7.2-36 (2005) (imposing a Business, Professional and Occupational License (BPOL) tax based on gross receipts). *See also* 18 VAC 50-22-10 (2005) through 18 VAC 50-22-270 (2005), *available at* http://www.state.va.us/dpor/Contractors%20Web.pdf

seeking access to business license tax filings and comparing gross receipts, as reported on those filings, with gross income reported on the taxpayer's federal income tax return. This comparison could help the IRS identify businesses that may be underreporting their income or not filing at all.

D. The IRS Should Strive to Achieve the Correct Results – Not Merely the Results That Maximize Revenue.

When an IRS employee conducts an audit and ultimately assesses and collects additional tax, the IRS views the audit as successful. TAS has found, however, that many taxpayers who "lose" issues on audit and agree to pay additional tax do not, in fact, owe additional tax. "Successful" audits that produce wrong results probably occur most frequently in audits of taxpayers who have the greatest difficulty understanding and complying with IRS requests, particularly via correspondence audits. Low income, elderly, visually or hearing-impaired, and limited-English-proficiency taxpayers are particularly likely to agree to an IRS adjustment, even if wrong, because of their inability to understand the issue and then locate and present the documentation required to substantiate their positions.

In 2004, TAS conducted a study of cases in which EITC claims had been denied and the taxpayer requested reconsideration of the initial IRS determination.[21] In these cases, 43 percent of taxpayers ultimately received the EITC, and the amount received was, on average, 94 percent of the amount claimed on the original return. In essence, the likelihood that the IRS had obtained the right result the first time was not much better than a coin toss would produce. The study also highlighted the significance of talking with the taxpayer – not merely corresponding – in obtaining the right result. When TAS employees initiated contact with taxpayers by phone instead of relying solely on correspondence, both the likelihood of the taxpayer receiving additional EITC and the amount of EITC received increased with the number of phone calls made by the TAS employee.

Finally, the study found that taxpayers who do not respond to notices are typically no less entitled to prevail in an audit than taxpayers who respond timely. Although many research and academic experts who have examined the EITC program had assumed that non-responders and late responders would be less likely to qualify for EITC benefits than taxpayers who timely responded to requests for information, the study showed that both groups qualified at the same rate. This result is not altogether surprising. For EITC taxpayers – many of whom have low education levels, keep limited records, and may be intimidated at the prospect of battling against the IRS – the failure to pursue a claim may reflect nothing more than difficulty in determining how to pursue it.

(requiring contractors to obtain different contractor license classes based on the value of the contractors' jobs).

[21] *See* National Taxpayer Advocate 2004 Annual Report to Congress, Vol. II, *Earned Income Tax Credit (EITC) Audit Reconsideration Study*.

The IRS should not focus on collecting additional revenue at the expense of obtaining the correct result. It is just as important for the IRS to avoid collecting too much tax from taxpayers who don't owe it as to collect taxes due from those who have underpaid.

E. Going Where the Money Is: The IRS Needs To Do More To Improve Compliance in the Cash Economy.

The National Research Program data confirm what most people would intuitively expect. Where taxable payments are reported to the IRS by third parties, the IRS generally collects well over 90 percent of the tax due.[22] Where taxable payments are not reported to the IRS by third parties, compliance drops precipitously, probably below 50 percent.[23] Indeed, the IRS estimates the compliance rate for self-employed taxpayers who file a Schedule C is approximately 43 percent, resulting in underpayment of approximately $68 billion in income taxes alone. For purposes of my testimony, I will use the term "cash economy" to mean all taxable payments that are not reported to the IRS by third parties.[24]

The cash economy may be responsible for more than a third of the tax gap. The IRS has no direct estimate of the portion of the tax gap attributable to the cash economy. However, according to IRS estimates:

- About 43 percent of the gross tax gap, or $148 billion a year, is attributable to underreporting of income and self employment taxes by self-employed individuals.[25]
- Over 80 percent of all individual underreporting is attributable to understated income rather than overstated deductions.[26]

These estimates suggest that self-employed taxpayers who file returns but underreport their income (or self-employment) taxes represent the single largest component of the tax gap, accounting for more than a third of the gap and over $100 billion per year.[27]

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[22] *See* IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

[23] *See* IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

[24] There is no universally agreed-upon definition of the term "cash economy." For a definition similar to mine, *see* Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate, 108th Cong. 21 (July 21, 2004) (statement of Professor Joseph L. Bankman defining the cash economy as "legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information reporting . . . your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting.").

[25] Taxpayers who underreport business income on individual returns account for $109 billion of the gross tax gap and those who underreport self-employment taxes account for another $39 billion. IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

[26] *See* IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

The IRS has devoted substantial resources in recent years to combating corporate tax shelters and trying to improve standards of conduct among tax professionals. But neither of these priorities addresses the biggest components of the tax gap.

In my annual reports to Congress and in previous congressional testimony, I have offered numerous proposals to help the IRS do a better job at combating the cash economy portion of the tax gap.

Earlier this year, the Small Business/Self Employed Division agreed to establish a joint task force with my office to explore alternatives for improving compliance in the "cash economy" portion of the tax gap. The task force will focus on business transactions conducted on a cash basis where there is currently little or no information reporting. The task force held an initial meeting in April.

The initial goal of the task force is to survey both internal and external sources to identify ideas for improving compliance in this segment of the economy. Task force members are reviewing information from an extensive list of data sources, including the following:

- IRS and TAS studies and recommendations, including the National Taxpayer Advocate's annual reports to Congress.
- Joint Committee on Taxation (JCT), TIGTA, and GAO studies.
- Academic studies.
- Initiatives undertaken by the states and foreign governments.
- State databases containing sales tax, licensing, and other information.
- Contact points with the Treasury Department's Office of Tax Analysis (OTA) and the IRS Federal/State Program.
- Suggestions collected from IRS employees through an internal web site.

The task force will develop ranking criteria and complete a ranking process. Ranking criteria will be used to identify the most promising ideas, which will be further researched before a final ranking is developed. We anticipate that the team will present the ranked list to the Commissioner of SB/SE and the National Taxpayer Advocate for consideration.

After obtaining guidance from the Commissioner of SB/SE and the National Taxpayer Advocate, the team intends to fully develop and implement the most promising proposals. This could entail vetting ideas with important external stakeholders, developing legislative and budget proposals, developing implementation plans, and

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[27] *See* IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

gaining the necessary support from both internal and external organizations to accomplish implementation.

I am hopeful this task force will lead to improved efficiency in IRS operations. As I will discuss below, however, there are limits to what the IRS can do absent congressional action.

IV. Significant Improvements in Tax Compliance Are Unlikely Without Congressional Action.

Notwithstanding my strong belief that the IRS can do more to improve voluntary compliance, the IRS is unlikely to make major strides unless Congress takes steps to make it easier for the IRS to detect noncompliance, primarily through expanded third-party information reporting or withholding. Congress could also improve compliance by facilitating easier payments of estimated tax, improving the offer in compromise program, and strengthening standards in the tax return preparation industry.

A. To Reduce Opportunities for Noncompliance in the Cash Economy, Third-Party Information Reporting Should Be Expanded in Appropriate Cases.

Where payments are subject to withholding, the reporting compliance rate is 99 percent. Where payments are subject to third-party information reporting (e.g., interest and dividend income), reporting compliance is the neighborhood of 96 percent. But where there is little to no information reporting, compliance plummets dramatically to somewhere in the range of about 50 percent overall. This is hardly surprising. Where taxpayers know the IRS is aware they have received income, they realize there is a paper trail and the IRS is likely to come knocking if they fail to report the income on a return. Where taxpayers believe the IRS has no knowledge of an item of income, they realize the IRS is unlikely to find out about it and the temptation not to report it arises.

In considering proposals to expand third-party information reporting, we need to identify various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose.

On the one hand, it would be unacceptably burdensome to impose reporting requirements on all types of transactions. For example, no one wants to be obligated to file a document with the IRS every time he or she takes a cab ride, has someone mow the lawn, or calls a plumber to fix a broken faucet.

On the other hand, some advocacy groups contend that virtually all proposals to expand third-party information reporting are unreasonably burdensome. This position is equally unreasonable. For example, some groups argue that third-party information reporting places a burden on the wrong party. If the *recipient* of a payment fails to report income on his return, they argue, why should the government impose a reporting requirement on the *payor* of that income? After all, the payor hasn't done anything wrong.

The flaw in this argument is that the relatively high compliance rate we enjoy today derives entirely from placing the burden on the payor. When Congress first required employers to withhold taxes and file reports with the government on the payment of wages, similar arguments were raised in opposition. The employer wasn't the one failing to pay taxes, so why burden the employer? When Congress first required banks and other financial institutions to file reports with the government on the payment of interest and dividends, similar arguments were raised again. The financial institution wasn't failing to pay taxes, so why burden the financial institution?

Yet if Congress had not chosen to burden employers and financial institutions in this way, our overall tax compliance rate would likely be much closer to 50 percent than 84 percent. That would be terrible for our economy and for honest taxpayers – including payors of wages, interest, and dividends – since the government would have to double current tax rates to raise the same amount of revenue.

In my view, each proposal to expand third-party information reporting or withholding should be evaluated on its own to determine whether the likely revenue benefits outweigh the likely economic burden the requirement would impose. Let me describe a few situations where I think expanded third-party information reporting should be considered. Under current law, an individual taxpayer can escape information reporting by incorporating. This is true even if the taxpayer is performing the same services that would be subject to Form 1099-MISC (Miscellaneous Income) reporting if the taxpayer were conducting business as an unincorporated entity (*e.g., a* sole proprietorship).

For Form 1099-MISC information reporting purposes, I believe there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer has incorporated and another has not. There are, of course, many valid reasons for choosing to conduct business as a corporation, but information-reporting avoidance should not be such a reason. Corporate taxpayers who intend to comply with the tax law should have no objections to receiving a 1099-MISC for compensation for services performed or to IRS awareness of this compensation. Thus, we recommend that corporate taxpayers (including Subchapter S corporations) be subject to 1099-MISC reporting requirements to the same extent that unincorporated businesses are today.[28]

We also recommend that Congress consider requiring information reporting on gross proceeds from sales conducted on Internet auction sites. As with current rules governing Form 1099 reporting, such reports could be subject to a *de minimis* annual exemption (say, $600). One recent study found that 700,000 Americans reported that

[28] We initially recommended that only payments to corporations with 50 or fewer shareholders be subject to income reporting. In subsequent conversations with payroll and reporting professionals, we have been advised that it is often difficult for payors to know the payee's number of shareholders at any one time. These professionals recommend a unitary rule as easier to administer. The National Taxpayer Advocate believes that the precise scope of a corporate reporting requirement should be determined after appropriate research and discussions with affected stakeholders.

eBay sales constitute their primary or secondary source of income.[29] The IRS must have the tools needed to address under-reporting of this income.

To cite another example, I recommended in the National Taxpayer Advocate's 2005 Annual Report to Congress that Congress consider requiring broker-dealers to track and report their customer's cost-basis in stocks and mutual funds when sales are made. Under existing rules, brokers are required to file a Form 1099-B (Proceeds from Broker and Barter Exchange Transactions) with the IRS whenever a customer sells a security. However, the reporting rules only require the broker to report the gross proceeds the customer receives upon the sale. The broker does not have to report the customer's cost basis in the security. That omission is significant because a taxpayer's gain or loss on the sale of a security is measured by the excess of gross proceeds over cost basis. Thus, it provides an opportunity for noncompliance.

The absence of a requirement that brokers track and report customers' cost basis in securities has two consequences. First, it often imposes significant compliance burdens on taxpayers who may not have kept track of their cost basis. To illustrate, a taxpayer who has held AT&T stock since the 1980s has received shares in more than a dozen companies over the years, and on each such occasion, the taxpayer's cost basis had to be split between his existing holding and the spun-off company. Similarly, most mutual fund customers elect to have dividend and capital gain distributions automatically reinvested, and the customer's aggregate basis in a mutual fund holding changes upon each such distribution. If taxpayers don't have complete records, they will be unable to determine or substantiate their basis in many instances. We recommended requiring brokers to track and report cost basis primarily because it would make life much easier for honest taxpayers.

But the second consequence of the absence of cost basis reporting is that it affords less honest taxpayers with significant opportunities to overstate their basis and therefore understate their tax liabilities. Reliable estimates of the amount of underreporting in this area are difficult to come by, but two professors have sized the problem at about $25 billion a year.[30] IRS officials studying the NRP data believe the revenue loss is lower, but they agree that the level of underreporting reaches into the billions of dollars. We have spoken with representatives of the brokerage industry and believe on balance that the revenue benefits of requiring brokers to track and report cost basis exceed the burdens the requirement would impose.[31]

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[29] John Cassidy, *Going Long,* The New Yorker, July 10 & 17, 2006, at 99 (citing an AC Nielsen study).

[30] Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question,* 106 Tax Notes 453 (Jan. 24, 2005).

[31] Congress could consider providing brokers with a one-time credit to offset the cost of implementing a comprehensive basis-tracking system.

B. Where Taxpayers in the Cash Economy are Substantially Noncompliant, the IRS Should Have Back-up Withholding Authority to Drive Compliance.

Because we know that income-reporting compliance is nearly 100 percent when payments are subject to withholding, we are compelled to examine the feasibility of requiring withholding on certain cash-economy payments. We must acknowledge that withholding can impose significant burdens on the payor and in many instances is administratively unworkable. Thus, I am not advocating universal withholding. But we should at least consider the feasibility of the following:

- Entering into voluntary withholding agreements under IRC § 3402(p)(3) with industries or trades that have established payor-payee mechanisms (*e.g.,* travel agencies and travel agents, or hair salons and stylists). The IRS, on a case-by-case basis, could agree to provide a safe-harbor worker classification where the payor enters into a voluntary withholding agreement.

- As discussed in more detail below, actively encouraging self-employed taxpayers to make monthly or even bi-weekly payments toward their estimated taxes through the government's Electronic Funds Transfer Payment System (EFTPS). Where a self-employed taxpayer has been noncompliant for several years running, the IRS could require that taxpayer to make these deposits and could monitor compliance with this requirement closely so as to intervene if the taxpayer misses a required payment. If the taxpayer consistently fails to make required payments, the IRS could impose a back-up withholding requirement, as described below.

- Amending IRC § 3406 to require a form of "backup withholding" by the payor in cases where a taxpayer-payee has a demonstrated history of noncompliance with the tax laws.

For over thirty years in the United Kingdom, contractors in the construction industry have been required to withhold on payments to independent contractors unless Her Majesty's Revenue and Customs (HMRC, formerly Inland Revenue) declares the independent contractor to be exempt from withholding. Independent contractors can obtain exemption certificates from HMRC by demonstrating compliance. This approach has the advantage of making it in the contractor's best interest to employ compliant subcontractors, since most contractors want to minimize their paperwork burden and avoid withholding requirements.

In the National Taxpayer Advocate's 2005 Annual Report to Congress, I recommended that Congress authorize the Secretary to exempt payors from back-up withholding on payments to taxpayers (independent contractors) who present payors with a valid IRS "Compliance Certificate." A taxpayer would be eligible for a Compliance Certificate if he or she has been in compliance with prior filing and payment obligations. If the taxpayer has been noncompliant, the IRS would still issue a Compliance Certificate if, for

example, the taxpayer makes arrangements to satisfy past obligations and schedules a year's worth of estimated tax payments through EFTPS.

The Compliance Certificate could serve as the mechanism for market-driven compliance. When an independent contractor presents a service-recipient with a valid Compliance Certificate, the service-recipient would know there is no risk of backup withholding on payments to that independent contractor. On the other hand, when an independent contractor does not have a valid Compliance Certificate, the service-recipient immediately would know that backup withholding on payments to this independent contractor is possible, if not likely. Moreover, if the service-recipient operates in an industry or industry segment where the IRS has determined that a significant number of substantially noncompliant independent contractors are operating, backup withholding could be mandatory on payments to independent contractors who do not present a valid Compliance Certificate.

Under this recommendation, market forces would act to oblige independent contractors to operate among the ranks of the tax compliant. The easiest way for a payor to avoid a backup withholding situation would be to hire only independent contractors that present a valid Compliance Certificate. It follows that independent contractors who want to work would obtain Compliance Certificates. And in order to obtain a Compliance Certificate, an independent contractor would have to be tax compliant. Thus, tax compliance would become a condition of conducting business.

C. Many Taxpayers Not Subject to Withholding Cannot Save Enough Money to Pay Their Tax Bills, So in Appropriate Cases, We Should Encourage Taxpayers to Schedule Monthly Payments as Automatic Debits from Their Checking Accounts.

Taxpayers who want to comply with their estimated tax payment obligations sometimes fail because the process of estimating income, remembering payment dates, and saving enough money each quarter is cumbersome, especially for self-employed taxpayers who are juggling many different duties and many competing demands on both time and funds. Anything that the IRS can do to help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make such payments is likely to increase compliance.

The IRS should make it just as easy for taxpayers to make their estimated tax payments as it is to pay other bills. Most other creditors send customers bills to remind them when a payment is due, and many creditors offer the option of paying via automatic monthly withdrawals from the customer's bank account free of charge.[32] Similarly, the

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[32] The Treasury Inspector General for Tax Administration (TIGTA) previously recommended that the IRS clearly communicate to taxpayers that EFTPS is free. *See* Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 24 (Feb. 2004). This recommendation was based on a taxpayer focus group consensus indicating that taxpayers would not use credit cards to make estimated tax payments because credit card companies charge a convenience fee. *Id.*

IRS could send letters each quarter to self-employed taxpayers who are not making tax payments using the Electronic Funds Transfer Payment System to remind them to make their estimated tax payments. These reminders could point out that taxpayers can use EFTPS, a free service, to make estimated tax payments electronically or by phone and to schedule payments in advance, just like automatic payments to a mortgage lender or utility.[33] The letters should also offer to accept estimated payments monthly or even bi-weekly, just like most other recurring bills.[34] Signing up taxpayers for EFTPS could make estimated tax payments almost as automatic as withholding, and that would substantially increase compliance.

D. The Offer in Compromise Program Should Be Strengthened Because It Brings in Revenue and Brings Taxpayers Into Long-Term Compliance.

I recommend that Congress consider measures to expand the offer in compromise program. While I believe the IRS already has the authority to expand this program under existing law, it has repeatedly declined to do so. Why? By definition, only noncompliant taxpayers submit offers since these taxpayers are asking to pay less than the amount the IRS has determined to be due. Thus, it may appear expensive to process and review an offer in compromise, and it may appear that the government is writing off revenue, which some argue may impact other taxpayers' compliance.

On balance, however, I think the offer in compromise program is a good deal for the government. A taxpayer who submits the offer will probably pay more tax dollars into the system in the future as a result of his promise – required with every accepted offer – to be fully compliant for the five succeeding years or else face reinstatement of the tax debt. Five years is a long enough period to enable this taxpayer to learn a new norm of behavior – namely, compliance. And when you compare the 16 cents on the dollar that IRS receives from offers to the virtually no cents it collects after year 3 of the 10-year collection period, many compliant taxpayers might feel that the IRS, by not promoting an efficient and cost effective offer program, is missing a valuable opportunity.

In 1998, Congress directed the IRS in committee report language to expand the bases for accepting offers by considering additional factors such as equity, hardship, and public policy.[35] The IRS has been very slow to approve offers on these bases. Although the IRS has begun to accept more of these "effective tax administration" offers in the past two years, it has failed to issue any meaningful guidance to taxpayers or its own employees about what factors it considers in accepting such offers. Thus, I have recommended that Congress consider providing more explicit direction.

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[33] Mortgage lenders often require borrowers to pay property taxes into escrow on a monthly basis to ensure that borrowers do not forget to make quarterly or semi-annual property tax payments or spend the funds elsewhere.

[34] Some mortgage companies offer programs that electronically deduct mortgage payments bi-weekly rather than monthly.

[35] H.R. Conf. Rep. No. 105-599.

I am also very concerned about legislation enacted earlier this year that requires taxpayers submitting lump-sum offers to make an up-front payment of 20 percent simply to have their offers considered.[36] I believe this requirement will reduce the number of meritorious offers the IRS receives and, to that extent, will actually result in a reduction in federal revenue.

Taxpayers generally must offer the net equity in their assets plus their future income, after allowance for necessary expenses, for several years.[37] Thus, taxpayers must fund offers with assets that the IRS would not ordinarily collect, such as home equity, qualified retirement plans (*e.g.*, an IRA), or unsecured loans or gifts from third parties.[38] Many taxpayers will be unable to access these funding sources to satisfy the 20 percent down payment requirement before the IRS has accepted the offer. For example, unless the IRS provides assurances that it will accept the offer:

- A mortgage lender will not lend against property subject to a tax lien;
- A taxpayer might be hesitant to withdraw funds from an IRA, incurring a 10 percent penalty for early withdrawal, because the IRS generally will not levy on a qualified plan, and if it does, no early withdrawal penalty applies;[39] and
- A third party such as a friend, relative, or employer who otherwise would give or loan funds for the offer might be less willing to provide funds because the third party cannot be sure those funds will help the taxpayer make a fresh start.

Taxpayers and third parties have no assurance an offer will be accepted at the time the 20 percent down payment is required, especially since the IRS accepted fewer than one in four offers in FY 2006 as of April.[40] Thus, many taxpayers who would otherwise be able to submit meritorious offers will not be able to do so because they cannot afford to pay 20 percent of the offer amount without any prior assurance that the IRS will accept the offer. Although I realize that Congress just enacted this provision, I think it is bad for taxpayers and bad for revenue. I encourage Congress to revisit this requirement.

E. Strengthening Standards for Unenrolled Return Preparers Would Reduce Noncompliance in the Cash Economy.

The majority of individual taxpayers today use the services of paid tax-return practitioners to prepare and file their individual tax returns, as do most business

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[36] *Tax Increase Prevention & Reconciliation Act of 2005*, § 509 (amending section 7122 of the Internal Revenue Code).

[37] The number of years varies based on the payment term: four years for lump-sum offers, five years for short term deferred payment offers or, for deferred payment offers, the period remaining before expiration of the statute of limitations for collection. *See* Form 656, *Offer In Compromise*, 6 (Rev. 7-2004).

[38] For example, the IRS generally does not levy on retirement plan assets unless the taxpayer's behavior has been "flagrant." IRM § 5.11.6.2 (Mar. 15, 2005).

[39] IRC § 72(t).

[40] SB/SE, Offer in Compromise Program, Executive Summary (FY 2006 (through April 30, 2006)).

taxpayers. Attorneys, certified public accountants, and enrolled agents are all licensed by state or federal authorities, and their right to practice before the IRS is subject to revocation in the event of wrongdoing.[41] Yet there is virtually no federal oversight over "unenrolled" return preparers, who constitute the majority of tax return preparers today.

The IRS does not know how many unenrolled return preparers are actively preparing returns for a fee in the United States. Nor does it know what qualifications and education these preparers possess to prepare returns. While the IRS has a number of initiatives that address the perpetration of criminal schemes by tax preparers, it only conducts a small number of preparer negligence investigations and it collects even fewer dollars in the rare instances that it assesses a preparer negligence penalty.[42]

Given the role that preparers play in guiding taxpayers through our complex tax laws, it is incumbent on the IRS to register and identify unenrolled return preparers and to administer a basic examination that ensures that persons who prepare returns for a fee have a basic level of competency. The test should contain an ethics component, so that preparers understand the ethical (as well as legal) obligation to accurately report income and expenditures. Moreover, an ongoing education requirement would ensure that preparers are current on tax law changes and learn from the most common mistakes. For example, the most common type of underreporting by taxpayers filing Schedules C (Profit or Loss from Business (Sole Proprietorship)) relates to understated gross receipts or overstated cost of goods sold. With respect to the latter issue, inventory accounting rules are very complex. Unenrolled preparers may not be aware of these complex provisions and thus carry errors forward from one year to the next.

V. Simplifying the Tax Code Would Go A Long Way Toward Improving Compliance.

The legislative actions I described above would help improve the transparency of payments and, to that extent, would largely reduce the opportunities for taxpayers to knowingly understate their income. As I also described earlier, however, many if not most taxpayer errors result from inadvertence and the challenges of understanding and complying with the tax code's numerous and complex requirements. The tax code runs approximately 1.5 million words, and the administrative guidance interpreting the Code could fill a small library.

Inadvertent errors would diminish dramatically if Congress were to simplify the tax rules dramatically.

I have made specific proposals to simplify portions of the tax code in my annual reports to Congress and in testimony I gave last year before the President's Advisory Panel on Federal Tax Reform. A detailed description of these proposals is beyond the scope of today's hearing, but a few examples will illustrate my point:

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[41] Circular 230, § 10.50(a).

[42] General Accounting Office, GAO-04-70, *Tax Administration: Most Taxpayers Believe They Benefit From Paid Preparers, But Oversight for IRS Is A Challenge* 16 (October 2003).

- The earned income tax credit (EITC), a tax provision designed to benefit poor or generally less educated taxpayers, contains 2,680 words and 13 subsections and generally requires at least a 12th grade education to understand. The EITC Information Package published by the IRS contains 53 pages of forms, instructions, and worksheets. Is it any wonder the misreporting rate is high?

- The alternative minimum tax (AMT) is so complex that many affected taxpayers don't realize they owe AMT until they prepare their returns. Although the AMT was originally designed to prevent wealthy taxpayers from using loopholes to escape paying taxes altogether, it now requires millions of Americans who are already paying their fair share to compute their tax liabilities under two sets of rules – and then pay the higher of the two results. Under the regular tax rules, taxpayers are entitled to claim personal exemptions for each member of their family and to deduct state taxes. Under the unique logic of the AMT, the acts of having children or living in a high-tax state are considered tax-avoidance behavior and these tax benefits are lost. Is it any wonder that taxpayers frequently err in computing the AMT – or that taxpayers view the tax code with cynicism?

- Taxpayers saving for their own education or the education of their children face a bewildering array of at least nine separate education credits, deductions, and income exclusions, which collectively contain four different measurements of income, six different income threshold amounts, and three different definitions of "qualified higher education" expenses. Similarly, taxpayers saving for retirement face an array of more than a dozen tax-advantaged retirement planning vehicles. Is it any wonder that taxpayers find the choices confusing or that so many taxpayers inadvertently run afoul of the requirements of these provisions, such as the minimum-distribution or the hardship-withdrawal rules?

Of course, these are just a few examples. But they illustrate why so many taxpayers make inadvertent errors, and they highlight the potential compliance gains we could achieve if Congress were to streamline these provisions and make them accessible to the average taxpayer.

VI. Conclusion

To reduce the tax gap, Congress and the IRS must focus on ways to increase voluntary compliance with the tax code. There is no one-size-fits-all solution. Taxpayers fail to comply with the code for a variety of reasons, and the IRS needs to get a better handle on those reasons in order to develop a more effective compliance strategy. Through an effective combination of improved education, outreach, and assistance and targeted enforcement action, the IRS can improve voluntary compliance. But to make a real dent in the problem, Congress must act. Congress should increase the transparency of economic transactions through third-party information reporting and withholding, in appropriate circumstances, to enable the IRS to detect noncompliance, and Congress should simplify the tax code to make it easier for taxpayers to comply with its requirements.

The largest contributor to the tax gap is the cash economy. The exhibits that follow summarize several proposals I have made in my annual reports to Congress to improve compliance in the cash economy.

Exhibit A: Cash Economy–Administrative Recommendations

Recommendation		Summary	Reason
1	Expand use of EFTPS	Send self-employed taxpayers a letter to remind them when estimated tax payments are due and offer the option of paying electronically, by phone or via automatic monthly (or biweekly) withdrawals from the taxpayer's bank account free of charge.	Self employed taxpayers who want to comply with their estimated tax payment obligations sometimes fail because they have difficulty estimating income, remembering oddly spaced payment dates (April 15, June 15, September 15 and January 15), and saving enough money each quarter. When they fail to pay enough estimated taxes, they are more likely to understate their liability.
2	Revise Form 1040, Schedule C	Include separate lines showing (1) the amount of income reported on Forms 1099 and (2) other income not reported on Forms 1099.	This revision would encourage taxpayers to report income even if it is not subject to information reporting. Taxpayers are more likely to report income that is reported to the IRS by third parties on information returns, such as Forms 1099. Some taxpayers appear to believe that income not reported on information returns is not subject to tax or at least that the IRS will not notice if they do not report it. Separating out gross receipts on the income tax form as we propose would likely improve compliance by emphasizing to taxpayers that income not reported on information returns is still subject to tax. It may also suggest to them that the IRS will notice if they do not report any other income. Another benefit of such a revision is that it would allow the IRS to match the income reported on Schedule C with income reported on Forms 1099 more easily.
3	Revise business income tax return forms	Include two questions: (1) Did you make any payments over $600 in the aggregate during the year to any unincorporated trade or business? (2) If yes, did you file all required Forms 1099?	These two questions would encourage taxpayers to comply with information reporting requirements. They would also suggest to taxpayers that the IRS is looking at information reporting compliance and that there is additional risk to avoiding the information reporting requirements by paying contractors "under the table." Payments reported to the IRS on information returns are much more likely to be reported on the payee's income tax return. Thus, increased information reporting compliance would cause contractors (payees) to report more of their income.

Recommendation		Summary	Reason
4	Implement more voluntary withholding agreements	Encourage taxpayers to enter into voluntary withholding agreements by agreeing not to challenge the classification of workers who are a party to such an agreement. (Statutory authority exists under IRC § 3402(p)(3), but the IRS may need to work with the Treasury Department to issue regulations before it can use its authority and may prefer additional legislative authority.)	Research shows that taxpayers are most compliant in paying taxes on income subject to withholding. Unlike payments to employees, payments to independent contractors are generally not subject to withholding. Businesses sometimes have difficulty determining whether service providers should be classified as employees or independent contractors and the IRS often challenges such determinations. These agreements could reduce both underreporting by payees and the controversy associated with worker classification.
5	Institute backup withholding more quickly	Require mandatory backup withholding to begin more quickly when taxpayers provide an invalid TIN to the payor.	By the time a payor receives a backup withholding notice from the IRS, the payee (service provider) may no longer be receiving payments from the service recipient. Thus, the IRS has lost the opportunity for backup withholding. For additional information see National Taxpayer Advocate 2005 Annual Report to Congress 238-248 (MSP: Limited Scope of Backup Withholding Program).
6	Use more available information	Use more of the information available from state and local governments as well as information from Forms 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business) when selecting returns for audit and when auditing them.	The IRS currently uses information from Forms 8300 to identify returns that may have unreported income. It also receives and uses state income tax audit reports as well as sales tax records, which a cross-functional team has concluded could be used more consistently and effectively. States and localities also impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts. Such information may be useful in detecting unreported income. Local property taxes are also based on the value of real and personal property. Taxpayers whose property holdings are disproportionately large in comparison to the income reported on their federal income tax returns may be underreporting their income. The IRS could combine all of this information, perhaps in conjunction with the UI-DIF (or to improve it), for selecting returns for audit and auditing them.

Recommendation		Summary	Reason
7	Establish local compliance planning organizations	A local planning organization could work to identify local compliance challenges, direct the IRS's local response, and measure its effectiveness.	Because tax compliance trends and norms are frequently local, it will be difficult for the IRS to effectively address them without local feedback about how its strategies are affecting taxpayers in a given community. The IRS needs such information and feedback so that it can adjust its strategy to effectively address local compliance issues. If noncompliance is so commonplace in a local market that the price of a good or service does not reflect tax compliance costs, suppliers may be unable to both pay their taxes and compete. However, if the IRS could motivate a critical number of businesses in a given market to report their income, then the market price for their goods or services would increase so that businesses could both compete and pay their taxes. As the IRS's activity starts to affect market prices, research suggests it could produce a dramatic increase in voluntary compliance in the local cash economy as it changes local norms. A national cash economy program office could replicate successful local strategies nationwide.

Recommendation		Summary	Reason
8	Create a cash economy program office	The cash economy program office would coordinate research, outreach, and compliance efforts aimed at improving income reporting compliance among cash economy participants, as the EITC program office has done with respect to EITC compliance.	The EITC Program Office coordinates EITC related activities, measures the results of its initiatives and takes responsibility for ensuring that the program works as intended, even though it relies on many other parts of the IRS to achieve its goals. As with EITC initiatives, responsibility for initiatives that may improve income reporting by cash economy participants is dispersed throughout the IRS. Nobody at the IRS with the authority to coordinate research, outreach, and compliance efforts takes primary responsibility for reducing underreporting among cash-economy participants. As a result, the IRS is not as effective as it could be in improving compliance among cash-economy participants. For example, a cash-economy program office could work with IRS Research to measure the impact of initiatives to reduce underreporting by cash-economy participants. TIGTA and GAO generally agree that such measures would help the IRS to reduce the tax gap. A cash-economy program office could also be justified on the basis that the EITC has a program office and the amount of the tax gap attributable to cash-economy participants dwarfs the amount of the tax gap attributable to EITC claimants.
9	Educate cash economy participants	Educate cash economy participants about the benefits of reporting their income and study the effect of such efforts to determine whether they are cost effective.	In addition to the satisfaction of obeying the law and avoiding potential civil and criminal penalties and interest charges, such benefits may include, for example, an increase in retirement benefits; disability benefits; survivors benefits; Medicare benefits; access to credit; earned income tax credits; and the ability to gain admission to the U.S. or a visa-status adjustment for family members or employees. The IRS could test this concept by educating taxpayers through outreach and various media targeting cash-economy participants in communities where compliance is low and such benefits are not well known. Researchers have suggested that publicity about such benefits, when combined with other enforcement initiatives, may significantly improve reporting compliance in a given community.

Recommendation		Summary	Reason
10	Obtain more and better research	Sponsor research to identify the most effective use of IRS resources after taking into account the direct and indirect effects of IRS activities on tax revenue.	IRS researchers have previously estimated that the indirect effect of an average examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment. However, not all audits have the same effect on compliance. A dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing corporate tax shelters. On the other hand, a dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving EFTPS, and answering tax law questions, has a positive indirect effect on compliance. The IRS does not have current research to show where the next dollar is best spent. We do not even know whether the next dollar is better spent on enforcement or taxpayer service. Thus, in the absence of better research, the IRS cannot make fully informed resource-allocation decisions.

Exhibit B: Cash Economy – Legislative Recommendations

Recommendation		Summary	Reason
1	Amend IRC § 3406 to encourage compliance in certain cash-economy transactions	Amend IRC § 3406 to create a three-pronged reporting and payment system that encourages compliance by: ▪ Instituting backup withholding on payments to taxpayers who have demonstrated "substantial noncompliance"; ▪ Releasing backup withholding on payments to taxpayers who become "substantially compliant" and who agree to schedule and make future payments through the Electronic Funds Transfer Payment System (EFTPS); ▪ Providing that payors will not be required to institute backup withholding on taxpayers who present payors with a valid IRS "Compliance Certificate".	Current withholding and information-reporting provisions do not adequately capture income from transactions in the cash economy. Unreported payments include: ▪ Deliberate "under the table" cash payments. ▪ Payments that are reported with an invalid TIN or payee/TIN mismatch. ▪ Payments subject to information reporting that are not reported. Withholding is not required on payments to non-employees, and skirting information reporting requirements for payments to independent contractors is easy and relatively painless. Payors wishing to comply with their information-reporting obligations may be reporting payments to independent contractors who have supplied invalid TINs. Under existing provisions, these payors may not know that a payee's TIN is invalid until several payments have been made. Furthermore, the motivation to comply with current Forms 1099-MISC and W-9 requirements is not particularly compelling. The toll charge for a missing or incorrect Form 1099-MISC or W-9 is $50.
2	Amend IRC § 6302(h) to require IRS to promote estimated tax payments through EFTPS.	Amend IRC § 6302(h) to require IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by FY 2012.	Current law requires IRS to use EFTPS to collect at least 94 percent of depository taxes. In contrast, the IRS received less than one percent of all estimated tax payments through EFTPS in tax year 2004. Making estimated tax payments can be cumbersome, particularly for self-employed taxpayers. EFTPS has the potential to alleviate some estimated tax problems because it is convenient and relatively easy to use. Moreover, taxpayers can use EFTPS to schedule automatic estimated payments.

Recommendation		Summary	Reason
3	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding between independent contactors and service-recipients.	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding between independent contactors and service-recipients (as defined in IRC § 6041A(a)(1)), and to specify that independent contractors who enter into voluntary withholding agreements with payor service recipients will be treated as employees only to the extent specified in the agreements, and allow such independent contractors to continue to deduct ordinary and necessary business expenses under IRC § 162(a).	Some independent contractors may wish to enter into withholding agreements with their payors. It is currently unclear, however, whether statutory authority exists to enter into such agreements. IRC § 3402(p)(3) is silent on voluntary withholding agreements in the independent contractor/payor context. Section 3402(p)(3) is the only section under which a voluntary withholding agreement between a payor and an independent contractor would be permitted.
4	Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations.	Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations, as defined in IRC § 7701(2)(3) (including corporations electing to be taxed under subchapter S of the Internal Revenue Code).	Taxpayers report 96 percent of income from transactions subject to information reporting. The percentage of reported income decreases significantly, however, when transactions are not subject to information reporting. Under current law, an individual taxpayer can escape Form 1099-MISC information-reporting by incorporating. A taxpayer attempting to avoid 1099-MISC reporting need only include in its business name an indication that it is doing business as a corporation in order to release the service-recipient from the IRC § 6041A reporting requirements. For Form 1099-MISC information-reporting purposes, there should be no distinction between taxpayers who are incorporated and those who are not.

Exhibit C: Requiring Brokers to Track and Report Cost Basis – Legislative Recommendation

Recommendation	Summary	Reason
Amend IRC § 6045(a) to authorize the Secretary of the Treasury to require brokers to track and report cost basis in connection with the sale of mutual funds and stocks.	Amend IRC § 6045(a) to authorize the Secretary of the Treasury to prescribe regulations that require brokers to report information not only regarding gross proceeds but also regarding adjusted basis in connection with the sale of mutual funds and stocks. To facilitate accurate basis reporting, financial institutions that hold mutual funds or stocks for customers should, when a customer transfers assets to a successor financial institution, be required to provide the customer's adjusted basis in the transferred mutual fund and stock holdings to the successor financial institution.	When transactions are subject to information reporting to the government, tax compliance is generally very high – well over 90 percent. The opportunity for noncompliance upon sale of mutual funds or stocks is considerable under current law, because the taxpayer's basis is not reported to the government. This proposal also helps taxpayers (and that was our primary reason for proposing it.) Today, more Americans own stocks or mutual funds than ever before. Most mutual fund investors elect to have their dividend and capital gain distributions automatically reinvested in their funds, causing their aggregate adjusted bases to change upon each such reinvestment. Many mutual fund companies assist their investors by keeping track of adjusted basis, but some do not. With regard to stock investors, most brokers keep track of purchases their customers make, but they do not necessarily update their basis records to reflect stock splits, spin-offs, and other corporate restructurings. While taxpayers are properly required to keep adequate records to substantiate their tax reporting, the reality is that some investors hold stocks or mutual funds for decades, and it is simply not realistic to expect that all taxpayers will keep perfect records for long periods of time.

Responses to Questions for the Record From Nina Olson
Subcommittee on Taxation and IRS Oversight
Committee on Finance
"A Closer Look at the Size and Sources of the Tax Gap"
July 26, 2006

Responses to Questions from Senators Grassley and Kyl:

Question 1:
Enforcement vs. Service: Ms. Olson, in your testimony, you cited data from the NRP which shows that IRS auditors attributed only 3 percent of reporting inaccuracies to deliberate non-compliance. As the IRS is attempting to do more to reduce the tax gap, do you think it is appropriately balancing new taxpayer service initiatives and new enforcement initiatives, or do you think it should be doing more on the taxpayer service side?

Response 1:
I believe that both taxpayer service and enforcement are essential to ensuring tax compliance. I also believe that service and enforcement should not be approached as separate tracks as they are today. Rather, the IRS should integrate service within its enforcement activities.

Enforcement is best suited for circumstances in which taxpayers willfully seek to evade their tax obligations. The limited data available does suggest that the majority of taxpayer errors are inadvertent. Employing harsh enforcement measures against such inadvertently noncompliant taxpayers is unfair and may in fact lead to deliberate noncompliance.

Moreover, the IRS lacks the resources to close the gap by enforcement alone.[1] Enforcement must thus be targeted at and reserved for taxpayers who willfully seek to avoid paying taxes. I do believe, however, that the IRS should work to induce even willfully noncompliant taxpayers to comply voluntarily in the future.

In order to strike the appropriate balance between taxpayer service and enforcement, the IRS must conduct more and better research on both the direct and indirect effects of its activities on tax revenue. Such research is critical to help the IRS determine the most effective use of its resources and how it may get the most impact from each dollar spent.

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[1] *See* National Taxpayer Advocate 2006 Annual Report to Congress 6-9.

Question 2:
Considering Costs and Burdens: Ms. Olson, Mr. Brostek's testimony states that any action to reduce the tax gap will create costs and burdens for the IRS, taxpayers, and third parties. He rightly points out that these costs and burdens need to be reasonable in relation to the improvements expected to arise from new compliance strategies.

In your testimony, you recommend an evaluation of information reporting or withholding proposals to determine whether the likely revenue benefits outweigh the burdens the requirement would impose. You also made specific legislative recommendations to increase information reporting and withholding to combat the cash economy. When we and the IRS consider measures to close the tax gap, what should this type of benefit/burden analysis entail?

Response 2:
For the past three years, my office has considered the benefits and burdens of several possible tax gap reduction initiatives. After considering these benefits and burdens, I have recommended those initiatives that I believe provide the most benefit and impose reasonable burdens. Both Congress and the IRS could adopt a similar approach when considering various tax gap reduction measures.

In my 2004 Annual Report to Congress (ARC), I presented a list of several possible tax gap reduction measures and listed possible benefits and possible burdens of each.[2] I then considered the burdens associated with each measure and labeled those measures that would impose the most burden on taxpayers as "Most Intrusive," the measures that would impose a moderate amount of burden as "Somewhat Intrusive," and the measures that would impose little or no burden on taxpayers as "Least Intrusive."[3] I did not recommend or oppose any particular tax gap reduction initiative on the list. Instead, I aimed to present our analysis of the benefits and burdens of a wide array of possible tax gap reduction measures.

After considering the benefits and burdens of these various measures, I made several administrative and legislative tax gap reduction recommendations in my 2005 ARC.[4] I believe that the benefits of implementing these recommendations outweigh the burdens they would place on taxpayers. These recommendations were summarized in Exhibits A and B to my written testimony.

My office continues to study the components of the tax gap, think about various proposals that would narrow the gap, and analyze the benefits and burdens of each proposal. In conducting our analysis, we try to evaluate each proposal on a case-by-case basis and determine whether the benefits of implementing any specific proposal would outweigh the burdens it would impose.

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[2] National Taxpayer Advocate, 2004 Annual Report to Congress 483-489.

[3] *Id.*

[4] National Taxpayer Advocate, 2005 Annual Report to Congress 55-75 and 381-396.

Our continuing benefits and burdens analysis of various tax gap reduction proposals has caused us to refine some of the proposals first presented in my 2005 ARC and to make new proposals not contained in that report. I have listed my various legislative proposals, along with the benefits and burdens of each proposal, in Exhibit A to these Questions for the Record.

Question 3:
Business Income Underreporting: Ms. Olson, we've heard from all our panelists this afternoon that addressing the tax gap will involve increased enforcement, more information reporting, and tax code simplification. According to the IRS's estimates, the largest chunk of the tax gap -- $109 billion -- is from underreported net business income by individuals. Can you please explain the roles that enforcement, information reporting, and tax code simplification might play in reducing this component of the tax gap? Are there any other measures that might address this component?

Response 3:
I have often associated the portion of the tax gap attributable to underreported net business income by individuals with the cash economy.[5] Thus, what I've said about enforcement, information reporting, and simplification with respect to the cash economy is equally applicable to the portion of the tax gap attributable to underreported net business income by individuals.

Enforcement. The IRS has devoted substantial resources in recent years to combating corporate tax shelters and trying to improve standards of conduct among tax professionals. Neither of these priorities, however, addresses the biggest components of the tax gap.

In my annual reports to Congress[6] and in previous congressional testimony, I have offered numerous proposals to help the IRS do a better job at combating the cash economy portion of the tax gap.

Information reporting. The NRP data confirm what most people would intuitively expect. Where taxable payments are reported to the IRS by third parties, the IRS generally collects well over 90 percent of the tax due.[7] Where taxable

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[5] *See* Hearing on IRS Enforcement: Is the Bulls-eye on Small Businesses?: Hearing Before the House Comm. on Small Business, 109th Cong. (April 5, 2006) (written testimony of Nina E. Olson, National Taxpayer Advocate) (available at http://www.irs.gov/pub/irs-utl/ntatestimonyhousesmallbiz040506.pdf); The Causes and Solutions to the Federal Tax Gap: Hearing Before the Senate Comm. on the Budget, 109th Cong. (Feb. 15, 2006) (written testimony of Nina E. Olson, National Taxpayer Advocate) (available at http://www.irs.gov/pub/irs-utl/nta_senbudget_taxgap_021506.doc); National Taxpayer Advocate, 2005 Annual Report to Congress 55-75 (Most Serious Problem: The Cash Economy).

[6] *See, e.g.,* National Taxpayer Advocate, 2006 Annual Report to Congress 6-9.

[7] *See* IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

payments are not reported to the IRS by third parties, compliance drops precipitously, probably below 50 percent.[8] The IRS estimates the compliance rate of self-employed taxpayers who file a Schedule C is approximately 43 percent.

Thus, notwithstanding my strong belief that the IRS can do more to improve voluntary compliance under current law, the IRS is unlikely to make major strides unless Congress takes steps to make it easier for the IRS to detect noncompliance through expanded third-party information reporting in appropriate cases.

In considering proposals to expand third-party information reporting, we need to identify various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose.

On the one hand, it would be unacceptably burdensome to impose reporting requirements on all types of transactions. For example, no one wants to be obligated to file a document with the IRS every time he or she takes a cab ride, has someone mow the lawn, or calls a plumber to fix a broken faucet.

On the other hand, some advocacy groups contend that virtually all proposals to expand third-party information reporting are unreasonably burdensome, and this position is equally unreasonable. For example, some groups argue that third-party information reporting places a burden on the wrong party. If the *recipient* of a payment fails to report income on his return, they argue, why should the government impose a reporting requirement on the *payor* of that income? After all, the payor hasn't done anything wrong.

The flaw in this argument is that the relatively high compliance rate we enjoy today derives entirely from placing the burden on the payor. When Congress first required employers to withhold taxes and file reports with the government on the payment of wages, similar arguments were raised in opposition. The employer wasn't the one failing to pay taxes, so why burden the employer? When Congress first required banks and other financial institutions to file reports with the government on the payment of interest and dividends, similar arguments were raised again. The financial institution wasn't failing to pay taxes, so why burden the financial institution?

Yet if Congress had not chosen to burden employers and financial institutions in this way, our overall tax compliance rate would likely be much closer to 50 percent than 84 percent. That would be terrible for our economy and for honest taxpayers – including payors of wages, interest, and dividends – since the

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[8] *Id.*

government would have to double current tax rates to raise the same amount of revenue.

In my view, each proposal to expand third-party information reporting or withholding should be evaluated on its own to determine whether the likely revenue benefits outweigh the likely economic burden the requirement would impose. Let me describe a few situations where I think expanded third-party information reporting should be considered. Under current law, an individual taxpayer can escape information reporting by incorporating. This is true even if the taxpayer is performing the same services that would be subject to Form 1099-MISC (Miscellaneous Income) reporting if the taxpayer were conducting business as an unincorporated entity (*e.g.,* a sole proprietorship).

For Form 1099-MISC information reporting purposes, I believe there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer has incorporated and another has not. There are, of course, many valid reasons for choosing to conduct business as a corporation, but information-reporting avoidance should not be one of them. Corporate taxpayers who intend to comply with the tax law should have no objections to receiving a 1099-MISC for compensation for services performed or to IRS awareness of this compensation. Thus, I recommend that corporate taxpayers (including Subchapter S corporations) be subject to 1099-MISC reporting requirements to the same extent that unincorporated businesses are today.[9]

I also recommend that Congress consider requiring information reporting on gross proceeds from sales conducted on Internet auction sites. As with current rules governing Form 1099 reporting, such reports could be subject to a *de minimis* annual exemption (say, $600). One recent study found that 700,000 Americans reported that eBay sales constitute their primary or secondary source of income.[10] The IRS must have the tools needed to address under-reporting of this income.

To cite another example, I recommended in my 2005 ARC that Congress consider requiring broker-dealers to track and report their customer's cost-basis in stocks and mutual funds when sales are made. Under existing rules, brokers are required to file a Form 1099-B (Proceeds from Broker and Barter Exchange Transactions) with the IRS whenever a customer sells a security. However, the reporting rules only require the broker to report the gross proceeds the customer

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[9] I initially recommended that only payments to corporations with 50 or fewer shareholders be subject to income reporting. In subsequent conversations with payroll and reporting professionals, I have been advised that it is often difficult for payors to know the payee's number of shareholders at any one time. These professionals recommend a unitary rule as easier to administer. I believe that the precise scope of a corporate reporting requirement should be determined after appropriate research and discussions with affected stakeholders.

[10] John Cassidy, *Going Long,* The New Yorker, July 10 & 17, 2006, at 99 (citing an AC Nielsen study).

receives upon the sale. The broker does not have to report the customer's cost basis in the security. That omission is significant because a taxpayer's gain or loss on the sale of a security is measured by the excess of gross proceeds over cost basis. Thus, the lack of cost-basis reporting provides an opportunity for noncompliance.

The absence of a requirement that brokers track and report customers' cost basis in securities has two consequences. First, it often imposes significant compliance burdens on taxpayers who may not have kept track of their cost basis. To illustrate, a taxpayer who has held AT&T stock since the 1980s has received shares in more than a dozen companies over the years, and on each such occasion, the taxpayer's cost basis had to be split between his existing holding and the spun-off company. Similarly, many mutual fund customers elect to have dividend and capital gain distributions automatically reinvested and the customer's aggregate basis in a mutual fund holding changes upon each such distribution. If taxpayers don't have complete records, they will be unable to determine or substantiate their basis in many instances. I recommended requiring brokers to track and report cost basis primarily because it would make life much easier for honest taxpayers.

But the second consequence of the absence of cost basis reporting is that it provides less honest taxpayers with significant opportunities to overstate their basis and therefore understate their tax liabilities. Reliable estimates of the amount of underreporting in this area are difficult to come by, but two professors have sized the problem at about $25 billion a year.[11] IRS officials studying the NRP data believe the revenue loss is lower, but they agree that the level of underreporting reaches into the billions of dollars. We have spoken with representatives of the brokerage industry and believe on balance that the revenue benefits of requiring brokers to track and report cost basis exceed the burdens the requirement would impose.[12]

Simplification. As I explain in my written testimony, many, if not most, taxpayer errors result from inadvertence and the challenges of understanding and complying with the tax code's numerous and complex requirements. The tax code runs approximately 1.5 million words, and the administrative guidance interpreting the Code could fill a small library. Tax complexity is even greater for self-employed Schedule C filers because these taxpayers must grapple with a patchwork of rules that cover additional items such as business expense deductions (e.g., depreciation), numerous and overlapping filing requirements for employment taxes, and vague factors that govern the classification of workers as either employees or independent contractors.

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[11] Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question,* 106 Tax Notes 453 (Jan. 24, 2005).

[12] Congress could consider providing brokers with a one-time credit to offset the cost of implementing a comprehensive basis-tracking system.

Inadvertent errors would diminish dramatically if Congress were to simplify the tax rules dramatically.

I have made specific proposals to simplify portions of the tax code in my annual reports to Congress and in testimony I gave last year before the President's Advisory Panel on Federal Tax Reform. Examples of proposals that would simplify tax compliance for self-employed Schedule C filers include:

- Amending the Internal Revenue Code (the Code) to allow married couples operating businesses as co-owners to elect out of the partnership provisions of the Code;[13]
- Repealing section 162(l)(4) of the Code to allow self-employed individuals to deduct the cost of health insurance in computing the net earnings of a sole proprietor from self-employment;[14]
- Amending the Code to reduce or eliminate the Federal Tax Deposit avoidance penalty when a taxpayer has made a timely deposit but failed only to make such deposit in the prescribed manner;[15]
- Repealing the alternative minimum tax (AMT) for individuals;[16]
- Regulating unenrolled return preparers to help ensure that self-employed tax returns are prepared accurately, which would serve to prevent the burdensome IRS administrative and enforcement procedures associated with incorrect returns;[17] and
- Authorizing the Secretary of the Treasury to grant a one-time abatement of the failure-to-file and failure-to-pay penalties for taxpayers who have a history of compliance.[18]

Other measures. Another compliance measure applicable to self-employed Schedule C filers that I have written about extensively is withholding on certain cash economy payments. Because we know that income-reporting compliance

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[13] *See* National Taxpayer Advocate, 2004 Annual Report to Congress 401-402 and 2002 Annual Report to Congress 172-184. This proposal has been enacted into law.

[14] *See* National Taxpayer Advocate 2004 Annual Report to Congress 388-389 and 2001 Annual Report to Congress 223.

[15] *See* National Taxpayer Advocate 2004 Annual Report to Congress 400 and 2001 Annual Report to Congress 222.

[16] *See* National Taxpayer Advocate 2005 Annual Report to Congress 375, 378; 2004 Annual Report to Congress 383-385; and 2003 Annual Report to Congress 5-19.

[17] *See* National Taxpayer Advocate 2003 Annual Report to Congress 270-301 and 2002 Annual Report to Congress 216-230.

[18] *See* National Taxpayer Advocate 2001 Annual Report to Congress 188-192.

is nearly 100 percent when payments are subject to withholding, we are compelled to examine the feasibility of requiring withholding on these payments. We must acknowledge that withholding can impose significant burdens on the payor and in many instances is administratively unworkable. Thus, I am not advocating universal withholding. But we should at least consider the feasibility of the following:

- Entering into voluntary withholding agreements under Internal Revenue Code (IRC) § 3402(p)(3) with industries or trades that have established payor-payee mechanisms (*e.g.,* travel agencies and travel agents, or hair salons and stylists). The IRS, on a case-by-case basis, could agree to provide a safe-harbor worker classification where the payor enters into a voluntary withholding agreement.

- As discussed in more detail below, actively encouraging self-employed taxpayers to make monthly or even bi-weekly payments toward their estimated taxes through the government's Electronic Funds Transfer Payment System (EFTPS). Where a self-employed taxpayer has been noncompliant for several years running, the IRS could require that taxpayer to make these deposits and could monitor compliance with this requirement closely so as to intervene if the taxpayer misses a required payment. If the taxpayer consistently fails to make required payments, the IRS could impose a back-up withholding requirement, as described below.

- Amending IRC § 3406 to require a form of "backup withholding" by the payor in cases where a taxpayer-payee has a demonstrated history of noncompliance with the tax laws.

Taxpayers who want to comply with their estimated tax payment obligations sometimes fail because the process of estimating income, remembering payment dates, and saving enough money each quarter is cumbersome, especially for self-employed taxpayers who are juggling many different duties and many competing demands on both time and funds. Anything that the IRS can do to help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make such payments is likely to increase compliance.

The IRS should make it just as easy for taxpayers to make their estimated tax payments as it is to pay other bills. Most other creditors send customers bills to remind them when a payment is due, and many creditors offer the option of paying via automatic monthly withdrawals from the customer's bank account free of charge.[19] Similarly, the IRS could send letters each quarter to self-employed

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[19] TIGTA previously recommended that the IRS clearly communicate to taxpayers that EFTPS is free. *See* Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 24 (Feb. 2004). This recommendation was based on a taxpayer focus group consensus indicating that taxpayers

taxpayers who are not making tax payments using the EFTPS to remind them to make their estimated tax payments. These reminders could point out that taxpayers can use EFTPS, a free service, to make estimated tax payments electronically or by phone and to schedule payments in advance, just like automatic payments to a mortgage lender or utility.[20] The letters should also offer to accept estimated payments monthly or even bi-weekly, just like most other recurring bills.[21] Signing up taxpayers for EFTPS could make estimated tax payments almost as automatic as withholding, and that would substantially increase compliance.

In cases where taxpayers in the cash economy are substantially noncompliant, the IRS should have back-up withholding authority to drive compliance. I have recommended in my 2005 and 2007 Annual Reports to Congress that payors be required to institute backup withholding on payments subject to information reporting (*i.e.*, non-employee compensation in excess of $600 paid in the course of a trade or business) to independent contractors specifically identified by the IRS as "substantially noncompliant."[22] The term "substantially noncompliant" would be defined by regulations. Generally, only contractors who had recently failed to pay income tax or self-employment tax liabilities on more than one occasion would be deemed substantially noncompliant. Backup withholding would be ceased when the IRS deems a contractor "substantially compliant." A contractor would be deemed "substantially compliant" if, for example, the contractor scheduled a year's worth of estimated tax payments through EFTPS or entered into an installment agreement or voluntary withholding agreement.

I had also previously proposed that payors be required to initiate withholding on payments in certain industries designated by the IRS as "at-risk" unless the contractor presented a "compliance certificate."[23] The IRS would issue a compliance certificate if a contractor were "substantially compliant." This recommendation was based on a prior version of the United Kingdom's "Construction Industry Scheme," recently revised as the "New Construction Industry Scheme" (NCIS). Under NCIS, contractors must withhold 30 percent of all payments for services to unregistered subcontractors, 20 percent of all payments to registered contractors, and nothing on payments to subcontractors

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would not use credit cards to make estimated tax payments because credit card companies charge a convenience fee. *Id.*

[20] Mortgage lenders often require borrowers to pay property taxes into escrow on a monthly basis to ensure that borrowers do not forget to make quarterly or semi-annual property tax payments or spend the funds elsewhere.

[21] Some mortgage companies offer programs that electronically deduct mortgage payments bi-weekly rather than monthly.

[22] National Taxpayer Advocate, 2005 Annual Report to Congress 383-389; National Taxpayer Advocate, 2007 Annual Report to Congress 498-500.

[23] National Taxpayer Advocate 2005 Annual Report to Congress 381, 386-388.

who qualify to be paid "in gross."[24] A subcontractor must satisfy various requirements, including tax compliance checks, to qualify to be paid in gross. Contractors must check with the tax administrator to determine the status of any subcontractor before making a payment. If the other recommendations discussed above are enacted, this part of my prior proposal may not be necessary.

Question 4:
Capital Gains Basis Reporting: One piece of the tax gap relates to capital gains. Both the GAO and the Taxpayer Advocate have weighed in on this issue. Recently, the GAO estimated that 38 percent of individual taxpayers who had securities transactions misreported their capital gains or losses for tax year 2001, often because they failed to accurately report the securities' basis. But the misreporting goes both ways – 64 percent underreported their income and 33 percent overstated their income. This data suggests that if basis reporting can be done right, with appropriate input from the financial services industry and the IRS, there could be significant benefits for both the government and taxpayers. Ms. Olson, can you please elaborate on:

Question 4 (1):
How can basis reporting improve compliance?

Response 4 (1):
The lack of a basis reporting requirement has two negative consequences. First, the absence of a requirement that brokers track and report customers' cost basis in securities often imposes significant compliance burdens on taxpayers who may not have kept track of their cost basis. If taxpayers do not have complete records, they will in many instances be unable to determine or substantiate their basis. Requiring brokers to track and report cost basis would make life much easier for honest taxpayers. Second, the absence of cost basis reporting affords less honest taxpayers with significant opportunities to overstate their basis and therefore understate their tax liabilities.[25] Requiring brokers to track and report cost basis would allow the IRS to detect errors in basis reporting absent costly audits.

Question 4 (2):
What are the most significant challenges to brokers in implementing basis reporting?

Response 4 (2):
Some brokers are presently tracking cost basis. Thus, the computer systems and programs required to track basis do exist. This proposal would increase the

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[24] For additional information, see http://www.hmrc.gov.uk/new-cis.

[25] Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question*, 106 Tax Notes 453 (Jan. 24, 2005).

administrative burden on those brokers who do not currently track cost basis. However, my office has spoken with representatives of the brokerage industry and I believe, on balance, that the revenue benefits of requiring brokers to track and report cost basis exceed the burdens the requirement would impose.

Question 4 (3):
How might those challenges be addressed?

Response 4 (3):
If Congress determines that the burdens the requirement would impose on brokers is significant, Congress could lessen the burden by providing brokers with a one-time credit to offset the cost of implementing a comprehensive basis-tracking system.

Question 4 (4):
What are some other options to improve compliance through additional or expanded withholding or information reporting requirements?

Response 4 (4):
Please see Response 3 above.

Question 5:
Simplification and Targeted Tax Benefits: In the GAO testimony, several areas are highlighted where Congress has chosen to influence social policies by providing tax incentives to subsidize or encourage certain activities. These include the many education tax incentives, the Earned Income Tax Credit, and tax incentives that use varying definitions of a "qualifying child." Many Senators who support keeping, and even expanding, these targeted tax benefits have complained the loudest about the tax gap.

Question 5 (1):
Do you believe it would be possible to combine the education tax incentives into one or two simple education benefits? Would that benefit taxpayers, as well as improve compliance? Should Congress consider doing the same with other areas of the tax code, like the many savings incentives?

Response 5 (1):
My 2004 ARC included a Key Legislative Recommendation to simplify the education tax incentives.[26] The existing provisions are extremely complex and difficult to navigate. In order to determine which incentive is most beneficial for the taxpayer's particular facts and circumstances requires the taxpayer to understand and differentiate between the varying student qualification standards, types of eligible education expenses, income thresholds, phase-out calculations, adjustments for inflation and cost-of-living, and expiration dates.

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[26] National Taxpayer Advocate 2004 Annual Report to Congress 403-422.

The complexity of the education provisions invariably leads to inadvertent errors and may even prevent some of the less financially literate taxpayers from receiving the full benefit of the incentives. Due to this concern, I recommended that Congress take the following steps, which are explained in more detail in my 2004 Annual Report:

- Consolidate the Hope Scholarship Credit and Lifetime Learning Credit of IRC § 25A into one credit that can be taken on a per student basis (rather than a per return basis);[27]
- Consider making any resulting credit available in advance and fully refundable;
- Provide uniform definitions for "student," "qualifying higher education expenses," and "eligible education institution;"
- Provide uniform income thresholds and phase-out calculations, both of which are adjusted for inflation; and
- Fund a comprehensive outreach program, which involves partnering the IRS with the Department of Education.

The simplification of education as well as other savings incentive provisions[28] will likely reduce inadvertent errors. More importantly, less financially literate taxpayers will have a greater opportunity to understand and benefit from tax incentives. However, it is imperative that any simplification is also combined with an effective outreach and education campaign.

Question 5 (2):
According to the GAO testimony, the IRS estimated that for tax year 1999, losses from the Earned Income Tax Credit were $10 billion. How could Congress improve administration of, and compliance with regard to, the Earned Income Tax Credit?

Response 5 (2):
The adoption of a Uniform Definition of Child in 2004 was the first step in simplifying the Earned Income Tax Credit (EITC). Despite this significant step towards simplification, taxpayers claiming the different family status provisions, including the EITC, Child Tax Credit, Dependency Exemption, Head of Household Filing Status, and the Child and Dependent Care Credit must still navigate a labyrinth of complex rules and requirements for each provision. Taxpayers claiming the EITC are also claiming many of the other family status provisions, the rules for which are often counter-intuitive and therefore lead to

[27] The recommendation also includes the proposal to consolidate the IRC § 25A credits with the IRC § 222 Deduction for Qualified Tuition and Related Expenses. However, this incentive expired after December 31, 2005.

[28] For a discussion of the Key Legislative Recommendation to simplify retirement savings incentives, see National Taxpayer Advocate, 2004 Annual Report to Congress 423–432.

many inadvertent errors, while providing opportunities for deliberate fraud in some instances.

In my 2005 Annual Report to Congress,[29] I made the following recommendations to build upon the simplification achieved with the Uniform Definition of the Child and further simplify the family status provisions:

- Combine the personal and dependency exemptions, Child Tax Credit, and aspects of the EITC into a single refundable Family Credit available to all taxpayers, regardless of income. Make one component of this Family Credit available to the taxpayer (or taxpayers, in the case of married couples) and another component available to any taxpayer who is the "main caregiver" of a qualifying child, with no cap on the number of children a taxpayer could claim as "main caregiver."
- Separate the Child and Dependent Care Credit into two credits with the Child Care Credit available to the taxpayer who claimed the Family Credit described above and the Dependent Care Credit available to taxpayers who provided primary care for members of the extended family inside or outside the home.
- Eliminate Head of Household filing status and allocate the tax benefits attributable to that filing status between the Family Credit and Dependent Care Credit.
- Replace the EITC with the Family Credit and a modified EITC that provides a refundable credit to low-income workers 18 and over, for whom no one filed as the "main caregiver," based solely on the taxpayer's earned income. Retain the investment income rule of IRC § 32(i) so that the benefits of this refundable credit go to low income taxpayers who do not have significant investments.

Question 6:
Unreliability of Tax Gap Data – how to proceed? Ms. Olson, given that we do not have reliable information on many portions of the tax gap as well as on such things as the indirect effect of enforcement activities on voluntary compliance and the distinction between inadvertent mistakes and deliberate misreporting, how should we and the IRS make decisions on addressing the tax gap?

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[29] See National Taxpayer Advocate 2005 Annual Report to Congress 397-406 (Key Legislative Recommendation: Tax Reform for Families: A Common Sense Approach). The President's Advisory Panel on Federal Tax Reform made a similar proposal. It proposed that the standard deductions, personal exemptions, Child Tax Credit, and head of household filing status be consolidated into a single Family Credit and that the EITC and refundable child tax credit be consolidated into a single Work Credit. *See* President's Advisory Panel on Federal Tax Reform, *Final Report*, 63-69 (Nov. 1, 2005).

Response 6:
The IRS currently lacks sufficient information to determine the most effective use of its resources. Additional research is needed in a number of areas to allow the Service to make better informed decisions in the future.

The IRS should have current information on all the major components of the tax gap. This information enables the Service to identify where the biggest compliance problems are. The recent NRP was a good start. It furnished important information on the current state of reporting compliance among individual taxpayers, but much additional research needs to be done to update our information on compliance for the other components. The Service must also make a commitment to continually refresh information for the various components to assure that our information remains current. This suggests that the IRS should have an on-going NRP process.

The IRS also needs to do additional research to determine how best to address compliance problems that it identifies through the NRP process. Central to this research is the need for a better understanding of the causes of noncompliance, because the most effective way to address a given compliance problem depends on why the taxpayer was noncompliant. A fundamental distinction is whether the noncompliance was inadvertent or intentional. In the case of inadvertent noncompliance, we should attempt to identify the cause for the taxpayer's error. This information could be captured as a part of the on-going NRP process and would enable the Service to directly address the root cause of the compliance problem. Some possible solutions would include improved customer service, outreach and education programs, and tax law simplification.

If the noncompliance is deliberate, enforcement action may be required, but in many cases increased information reporting might be a better solution. Studies should be conducted to identify new approaches to information reporting and to weigh the cost of enforcement against the burden that information reporting imposes on taxpayers. Even when the IRS determines that examinations are the best way to address a particular compliance problem, additional research may be needed. Research shows that in most cases, the indirect effects of enforcement actions are probably greater than the direct effects. Not all audits are equally effective, and we need better information on the indirect effects of audits by industry and type of audit (e.g., correspondence audit, office audit, field audit).

Question 7:
Cost-Benefit Analysis of Information Reporting: The GAO testimony notes that "designing new withholding or information reporting requirements to address underreporting can be challenging given that many types of income are already subject to at least some form of withholding or information reporting, there are varied forms of underreporting, and the requirements could impose costs and burdens on third parties."

Response 7:
Please see my response to Question 8, below.

Question 8 (a):
Can you recommend other ideas for innovative solutions for improving information reporting or withholding that would not impose unreasonable burdens on taxpayers?

Response 8 (a):
After conducting the benefits and burden analysis discussed in my response to Question 2, my office recommended the following information reporting and withholding proposals:

Information Reporting:

- Amend IRC § 6041A to require third-party information reporting for applicable payments to taxpayers doing business as corporations;
- Amend the IRC to require information reporting on gross proceeds from sales conducted on Internet auction sites; and
- Amend IRC § 6045(a) to authorize the Secretary of the Treasury to prescribe regulations that require brokers to report adjusted gross basis information in conjunction with the sale of mutual funds and stocks.

Withholding:

- Amend IRC § 6302(h) to require the IRS to promote making estimated tax payments through the IRS EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.
- Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding agreements between independent contractors and service-recipients (as defined in IRC § 6041A(a)(1)) and to specify that independent contractors who enter into voluntary withholding agreements with payor service recipients will be treated as employees only to the extent specified in the agreement that such independent contractors may continue to deduct ordinary and necessary business expenses under IRC § 162(a).
- Amend IRC § 3406 to require a form of backup withholding by the payor service recipient in cases where a taxpayer-payee has a demonstrated history of noncompliance with the tax laws.
- Amend the IRC to authorize the Secretary of the Treasury to prescribe regulations creating a federal tax "Compliance Certificate" that would

exempt independent contractors (including government contractors) from any universal or backup withholding regime.

I have listed my various legislative proposals, along with the benefits and burdens of each proposal, in Exhibit A to these Questions for the Record.

Question 8(b): How do you recommend Congress balance the need for additional information with the need for taxpayers not to have unreasonable recordkeeping or reporting burdens imposed upon them?

Response 8(b):
In my 2004 ARC, I presented a chart listing various possible tax gap reduction initiatives and the various benefits and burdens of each initiative.[30] The chart also categorizes each initiative as "Most Intrusive," "Somewhat Intrusive," and "Least Intrusive," based on the level of burden it would impose on taxpayers and record keepers.[31]

Congress should undertake a similar benefits and burdens analysis as it considers various proposals for increasing information reporting in order to narrow the tax gap. Research demonstrates the benefits of more information reporting: when payments are reported to the IRS by third parties, the IRS collects well over 90 percent of the tax due.[32] When evaluating the burdens associated with various proposals to increase information reporting, I believe it is important to consider such things as whether payors are already reporting payments to certain service providers and a payor's ability to meet additional reporting requirements with systems and technology that are already in place.

For example, my proposal to expand information reporting to include certain payments to service providers doing business as corporations would likely have a negligible impact on a payor's recordkeeping burden because payors are currently required to report payments made to service providers doing business as sole proprietors. Current law already requires payors to file a Form 1099-MISC for most payments of $600 or more made to self-employed independent contractors.[33] Under my proposal, a payor would simply need to use its existing accounting system to generate Forms 1099-MISC for payments of $600 or more made to corporations, in addition to the Forms already generated for payments to sole-proprietors.[34]

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[30] National Taxpayer Advocate, 2004 Annual Report to Congress 483-489.

[31] *Id.*

[32] *See* IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2008-28 (Feb. 14, 2006) (accompanying charts).

[33] *See* IRC § 6041A(a).

[34] I discuss this proposal in more detail in my written testimony at page 14 and in National Taxpayer Advocate, 2005 Annual Report to Congress 394-396.

Question 9:
If Congress were to provide the IRS with additional funding to bolster its enforcement activities, what kind of return could we expect from that investment and when could we expect to see it?

Response 9:
In regard to the IRS collection program, the answer to this question depends on the manner in which the IRS would apply the additional funding to collect delinquent accounts receivable. In order to maximize the improvement of business results and taxpayer service, I believe much more emphasis is needed on early, meaningful interventions in IRS collection accounts, a point that I made in the 2006 ARC.[35] This approach will require a significant change in the IRS's traditional collection strategy, which places much more emphasis on the cumulative dollar amounts of delinquent tax cases than on the true age of its accounts receivable.

While standard business practices routinely acknowledge that the collectibility of delinquent accounts receivable rapidly diminishes with age, the IRS doesn't even systemically track the true age of its collection cases, *i.e.,* time elapsed from the due dates of the tax returns. Often, IRS collection cases do not receive "priority" treatment, *i.e.*, personal contact from an IRS collection employee, until the accounts have aged significantly and additional liabilities have accrued. For example, in fiscal year 2005, collection cases assigned to the IRS collection field function involved an average of 4.2 delinquent tax periods. As a result of these case assignment practices, a substantial number of collection cases are reported annually as uncollectible or are allowed to remain inactive in the IRS collection queue.

Early intervention also allows the IRS to engage delinquent taxpayers at a point in time when they are most likely to successfully resolve the tax debts and forego suffering economic hardships in doing so. If additional resources were applied first and foremost to "current" collection accounts, Congress could expect to see a significant return on investment, within a reasonably short period of time, *i.e.*, one to two years.

Question 10:
Would you discuss how we should balance our concerns about accuracy with our concerns about subjecting taxpayers to more audits in order to gather better information? Or is there a way to gather better information without increasing the number of full-scope audits?

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[35] National Taxpayer Advocate, 2006 Annual Report to Congress 62-82.

Response 10:
Where the IRS relies on examinations to identify underreporting for a particular class of returns (e.g., individual income as reported on the Form 1040 series of returns) during the NRP process, the IRS has taken a number of steps to reduce taxpayer burden. These steps include:

- IRS reduced the number of examinations it conducted during the NRP to fewer than 50,000, as compared to over 100,000 under the old Taxpayer Compliance Program (TCMP). It may not be advisable to further reduce the number of examinations. The IRS needs to conduct a sufficient number of examinations to be able to study important subsets of the taxpaying population in isolation – e.g., EITC taxpayers, self-employed taxpayers, etc.
- The IRS reduced the number of issues that would have to be addressed during the examination by using data available through electronic means to verify many return line items.
- Where possible, limited scope correspondence audits were used in lieu of face-to-face audits to reduce taxpayer burden (and IRS expense). Most audits still must be conducted face-to-face to assure accuracy, however, because they involve multiple complex issues.

The IRS is also investigating the use of operational data obtained from regular audits to reduce and supplement NRP examinations. There are limitations on this approach, however, since the total pool of returns selected for examination during the NRP must be representative of the entire taxpaying population and regular audits target only returns where the perceived risk of noncompliance is high.

As I stated previously, additional research needs to be done to update our information on compliance for many components of the tax gap for which we currently have outdated information. The Service must also make a commitment to continually refresh information for the various components to assure that our information remains current.

Question 11:
1993 Report: I think it is interesting that a 1993 report by the Treasury Department and the Office of Management and Budget determined that "enforcement is the most costly option and delivers only limited revenue." Do you agree? That same report found that "methods to increase voluntary compliance are less costly but more burdensome to taxpayers." Is this referring to increased reporting and/or withholding? Or to other options? Lastly, that report made several other recommendations that might still be instructive. Perhaps the most interesting revelation is TIGTA's comment that they were unable to determine if the report's recommendations were implemented. Do you know if any of the recommendations were implemented?

Response 11:
I believe that the 1993 report is referencing the fact that enforcement is not necessarily a very effective way of increasing voluntary compliance when compared to other approaches with greater "indirect effects," which may, in some cases, be more burdensome for taxpayers. For example, a dollar spent on expanded information reporting and withholding requirements would probably have a greater effect on voluntary compliance than a dollar spent on enforcement. However, the cost of information reporting and withholding is born by taxpayers whereas the cost of enforcement is partially born by the government.

The report makes a variety of recommendations, including some that do not involve additional withholding or information reporting, highlighting six of them in the executive summary:

1. Repeal the safe harbor of section 530 of the Revenue Act of 1978, which allows employers to classify workers as independent contractors without fear of challenge by the IRS, even if the workers would otherwise be classified as employees;
2. Require withholding on payments to independent contractors;
3. Require information reporting on gross bank deposits;
4. Require taxpayers to certify filing and payment of taxes to get business licenses;
5. Implement "Compliance 2000" initiatives for Schedule C filers, small corporations, informal suppliers, and those claiming net operating loss deductions; and
6. Implement hiring initiatives for Collection, Examination, and the Information Reporting Program.

TAS does not know why TIGTA indicated that it could not determine whether the IRS implemented any of the report's recommendations. Perhaps the age of the report contributed to TIGTA's uncertainty. TAS is similarly uncertain about whether the IRS made any progress in implementing the recommendations that did not require legislation.

Question 12:
Under current law, the IRS is required to keep accounts receivable on the books for ten years – and thus amounts that it knows are uncollectible cannot be written off for that period of time. Would it make sense to reduce that to a shorter length of time so that we have a truer picture of the accounts receivable inventory – e.g., six years?

Response 12:
The current ten-year collection statute was implemented through legislation passed by Congress in 1990. Prior to that legislative change, the collection statute expiration date (CSED) was six years from the date the tax was

statute expiration date (CSED) was six years from the date the tax was assessed. In a manner similar to the recent TIPRA changes involving the offer in compromise program, it is our understanding that the IRS did not request the extended CSED period, but Congress believed the additional time would help facilitate more tax collections and reduce the IRS's accounts receivable inventories. In theory, the extended CSED provides taxpayers an extended period of time to make payments on delinquent accounts. For example, ten years is a very common time frame for financing home equity loans. It also provides the IRS additional time to pursue collection on accounts that are deemed to be "currently" not collectible.

However, the CSED extension did not accurately take into account the true nature of *delinquent collection cases*, which generally do not improve over time. Studies regarding the collectibility of accounts receivable conducted by the IRS, as well as external sources such as Dun & Bradstreet and the Commercial Collection Agency Association of the Commercial Law League of America consistently reveal that accounts receivable that are over three years delinquent are generally not collectible. Historically, the IRS has annually collected less than 1% of the revenue dollars reported as "currently" not collectible, and we believe the extended ten-year CSED actually inhibits the use of collection payment alternatives, such as offers in compromise and installment agreements, by unrealistically projecting potential revenue collections obtainable from future tax payments. As such, we believe that reinstating the prior six-year CSED period would not only provide a more accurate picture of the accounts receivable inventory, but could also help facilitate the improved collection of delinquent tax accounts through better use of the IRS's collection payment options.

Question 13:
Ms. Olson, in your testimony you discuss a task force that has been established by the Small Business/Self Employed Division and the National Taxpayer Advocate's Office that will look at various data sources that may assist in fighting the tax gap. Could you please provide a timeline in terms of completing the ranking process, presenting the ranked list, and developing and implementing the most promising proposals? Also, of the data sources that the task force is looking into, you mention state databases containing sales tax, licensing, and other information. These state databases use publicly available data and compare it to tax return information to detect unreported income or unwarranted deductions. The states report that they are collecting hundreds of millions of dollars in tax revenues as a result of these databases. What impact would the use of data warehousing have on the tax gap and to what extent do you think it is feasible for the IRS to coordinate with these state databases?

Response 13:
The joint SB/SE-TAS task force on the cash economy completed a survey of internal and external sources (*e.g.,* TIGTA, GAO, academic research, foreign governments, etc.) regarding ideas for improving compliance in the cash

economy. TAS published its strategy for addressing the cash economy in the 2007 Annual Report to Congress.[36] While TAS's report was shared with SB/SE, the report is solely a TAS product.

It is feasible and important for the IRS to compare gross receipts, as reported on state filings available in state databases, with gross income reported on the taxpayers' federal income tax returns. This comparison could help the IRS identify businesses that may be underreporting their income or not filing at all.

Responses to Questions from Senator Hatch:

Question 1:
This is the third time this year you've been here speaking on the tax gap and I'm grateful for your thorough analysis of the subject. The Finance Committee has relied heavily on your testimony. When the full committee marked up the Taxpayer Protection and Assistance Act last month, we incorporated recommendations you had made at previous hearings, so thank you for all your excellent work. In connection with your emphasis on voluntary compliance – as opposed to enforced compliance, is there any source of income currently not subjected to withholding that you believe would be a good candidate for mandatory withholding?

Response 1:
As I explain in my written testimony, I believe that mandatory withholding should only be expanded to include payments to taxpayers that have a demonstrated history of noncompliance with the tax laws. Before implementing mandatory withholding on any taxpayer or taxpayer segment, I believe that legislative and administrative action should focus on voluntary withholding. To encourage voluntary withholding, I have recommended that (1) IRC section 3402(p)(3) be amended to specifically authorize voluntary withholding agreements between independent contractors and service recipients,[37] and (2) IRC section 6302(h) be amended to require the IRS to promote estimated tax payments through the IRS Electronic Federal Tax Payment System (EFTPS) and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2014. To help produce this result, I recommend that Congress use its oversight authority to ensure that the IRS makes EFTPS more user-friendly.[38]

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[36] See National Taxpayer Advocate 2007 Annual Report to Congress, Volume II, at 1-43.

[37] *See* National Taxpayer Advocate, 2005 Annual Report to Congress 391-394; National Taxpayer Advocate, 2007 Annual Report to Congress 493-494.

[38] *See* National Taxpayer Advocate, 2007 Annual Report to Congress 492-493. *See also,* National Taxpayer Advocate, 2005 Annual Report to Congress 389-391.

For those taxpayers that are willfully noncompliant, however, the IRS should have the authority to use backup withholding to drive compliance. I have recommended in my 2005 and 2007 Annual Reports to Congress that payors be required to institute backup withholding on payments subject to information reporting (*i.e.*, non-employee compensation in excess of $600 paid in the course of a trade or business) to independent contractors specifically identified by the IRS as "substantially noncompliant."[39] The term "substantially noncompliant" would be defined by regulations. Generally, only contractors who had recently failed to pay income tax or self-employment tax liabilities on more than one occasion would be deemed substantially noncompliant. Backup withholding would be ceased when the IRS deems a contractor "substantially compliant." A contractor would be deemed "substantially compliant" if, for example, the contractor scheduled a year's worth of estimated tax payments through EFTPS or entered into an installment agreement or voluntary withholding agreement.

I had also previously proposed that payors be required to initiate withholding on payments in certain industries designated by the IRS as "at-risk" unless the contractor presented a "compliance certificate."[40] The IRS would issue a compliance certificate if a contractor were "substantially compliant." This recommendation was based on a prior version of the United Kingdom's "Construction Industry Scheme," recently revised as the "New Construction Industry Scheme" (NCIS). Under NCIS, contractors must withhold 30 percent of all payments for services to unregistered subcontractors, 20 percent of all payments to registered contractors, and nothing on payments to subcontractors who qualify to be paid "in gross."[41] A subcontractor must satisfy various requirements, including tax compliance checks, to qualify to be paid in gross. Contractors must check with the tax administrator to determine the status of any subcontractor before making a payment. If the other recommendations discussed above are enacted, this part of my prior proposal may not be necessary.

Question 2:
Ms. Olson, how much of the tax gap might be attributable to taxpayer perception of complexity or unfairness of the tax system? In other words, are people purposefully cheating because they think the tax system is unfair or too hard to understand or because they might think that many of their friends and neighbors are doing it?

Response 2:
Although the IRS has little data about why taxpayers are noncompliant, the data that is available suggests that most taxpayers do not intend to become

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[39] National Taxpayer Advocate, 2005 Annual Report to Congress 383-389; National Taxpayer Advocate, 2007 Annual Report to Congress 498-500.

[40] National Taxpayer Advocate 2005 Annual Report to Congress 381, 386-388.

[41] For additional information, see http://www.hmrc.gov.uk/new-cis.

noncompliant.[42] For many noncompliant taxpayers, complexity is the primary cause of their noncompliance.[43]

Even among taxpayers who are intentionally noncompliant, the complexity of the IRC could motivate them to become noncompliant. However, the large number of inadvertent errors underscores the need to go beyond classifying taxpayers simplistically as "honest" or "dishonest" and to develop solutions designed to improve compliance among a broader range of taxpayers through an approach that includes components of both taxpayer service and enforcement.

Question 3:
What role in reducing the tax gap do you see, if any, for the Offers in Compromise Program? How can we best improve this program?

Response 3:
The best interest of the United States government and the American public is served when taxpayers fully satisfy their tax obligations in a timely manner. Unfortunately, for a wide variety of reasons, this is not always possible. The IRS needs to revamp its collection strategies to place much more emphasis on early, meaningful interventions in delinquent tax cases. In this manner, taxpayers who cannot fully pay their taxes when due have the opportunity to work out reasonable payment arrangements with the IRS, while the tax debt problems are relatively small and manageable. However, an analysis of IRS collection program results indicate that all too frequently, the lack of early, meaningful interventions in IRS collection cases contribute to less than desirable results. As of March 2006, over 723,000 taxpayer cases with delinquent balance due accounts resided in the IRS collection queue. Over $24 billion in delinquent taxes were associated with these accounts, and almost 30% of the accounts had been assigned to the queue for 16 months or longer. In FY 2005, over 794,000 taxpayer accounts were reported as currently not collectible (CNC). Of these, approximately two-thirds involved accounts that the IRS decided not to actively pursue due to their relative low priority in the IRS's inventory distribution system. In light of these conditions, we find it extremely difficult to believe that a more reasonable and flexible approach to using collection payment alternatives, such as offers in compromise and partial payment installment agreements would not

[42] One recent survey indicated that only 10 percent of respondents thought it was ok to cheat on their taxes by even a little bit and 82 percent said their own personal integrity was the most important factor influencing their tax compliance behavior. IRS Oversight Board, *2005 Taxpayer Attitude Survey*, 5-7 (Feb. 21, 2006), *available at* http://www.ustreas.gov/irsob/releases/2006/02212006.pdf.

[43] As I noted in my testimony, when IRS auditors conducted approximately 46,000 audits of individual taxpayers for purposes of the National Research Program (NRP), the auditors were asked, for each issue they identified, to characterize the reason for noncompliance. Among issues that IRS auditors examined that resulted in a change in tax liability, the auditors listed 67 percent as inadvertent mistakes, 27 percent as computational errors or errors that flowed automatically, and only three percent of errors as intentional. While the accuracy of this data may be open to question, it does suggest that many, if not most, errors are not intentional.

represent appropriate resolutions for many taxpayers, while also helping to put a significant dent in the tax gap.

The IRS has ample authority to use the offers in compromise program (OIC) as a viable and realistic payment option for many of these cases. Additionally, the IRS acknowledges the OIC as a viable alternative to reporting a collection account as currently not collectible. However, the collection results mentioned above do not reflect a sincere application of this policy to actual collection casework. I plan to explore in detail the disconnect between the IRS's public policy and the actual use of the OIC in the 2006 ARC. I believe the intent of Congress for a more flexible and realistic use of the OIC was clearly expressed in the Internal Revenue Service Restructuring and Reform Act of 1998. Recent reviews by the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA) have suggested that the IRS find ways to better utilize the OIC as a collection tool. Nevertheless, the number of accepted offers continues to decline. I believe this situation reflects a significant number of lost opportunities to reduce the tax gap, improve taxpayer service, and promote voluntary compliance.

As I noted in my testimony, OIC could play an important role in reducing the tax gap. I recommend that Congress consider measures to expand the program. While I believe the IRS already has the authority to expand this program under existing law, it has repeatedly declined to do so. Why? By definition, only noncompliant taxpayers submit offers since these taxpayers are asking to pay less than the amount the IRS has determined to be due. Thus, it may appear expensive to process and review an offer in compromise, and it may appear that the government is writing off revenue, which some argue may impact other taxpayers' compliance.

On balance, however, I think the OIC is a good deal for the government. A taxpayer who submits the offer will probably pay more tax dollars into the system in the future as a result of his promise – required with every accepted offer – to be fully compliant for the five succeeding years or else face reinstatement of the tax debt. Five years is a long enough period to enable this taxpayer to learn a new norm of behavior – namely, compliance. When you compare the 16 cents on the dollar that IRS receives from offers to the virtually no cents it collects after year three of the 10-year collection period, many compliant taxpayers might feel that the IRS, by not promoting an efficient and cost effective offer program, is missing a valuable opportunity.

In 1998, Congress directed the IRS in committee report language to expand the bases for accepting offers by considering additional factors such as equity, hardship, and public policy.[44] The IRS has been very slow to approve offers on these bases. Although the IRS has begun to accept more of these "effective tax

[44] H.R. Conf. Rep. No. 105-599.

administration" offers in the past two years, it has failed to issue any meaningful guidance to taxpayers or its own employees about what factors it considers in accepting such offers. Thus, I have recommended that Congress consider providing more explicit direction.

I am also very concerned about legislation enacted in 2006 that requires taxpayers submitting lump-sum offers to make an up-front payment of 20 percent simply to have their offers considered.[45] I believe this requirement will reduce the number of meritorious offers the IRS receives and, to that extent, will actually result in a reduction in federal revenue.

Taxpayers generally must offer the net equity in their assets plus their future income, after allowance for necessary expenses, for several years.[46] Thus, taxpayers must fund offers with assets that the IRS would not ordinarily collect, such as home equity, qualified retirement plans (*e.g.*, an IRA), or unsecured loans or gifts from third parties.[47] Many taxpayers will be unable to access these funding sources to satisfy the 20 percent down payment requirement before the IRS has accepted the offer. For example, unless the IRS provides assurances that it will accept the offer:

- A lender may not lend against property subject to a tax lien;
- A taxpayer might be hesitant to withdraw funds from an IRA, incurring a 10 percent penalty for early withdrawal, because the IRS generally will not levy on a qualified plan, and if it does, no early withdrawal penalty applies;[48] and
- A third party such as a friend, relative, or employer who otherwise would give or loan funds for the offer might be less willing to provide funds because the third party cannot be sure those funds will help the taxpayer make a fresh start.

Taxpayers and third parties have no assurance an offer will be accepted at the time the 20 percent down payment is required, especially since the IRS accepted fewer than one in four offers in FY 2006 as of April.[49] Thus, many taxpayers who would otherwise be able to submit meritorious offers will not be able to do so

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[45] *Tax Increase Prevention & Reconciliation Act of 2005*, § 509 (amending section 7122 of the Internal Revenue Code).

[46] The number of years varies based on the payment term: four years for lump-sum offers, five years for short term deferred payment offers or, for deferred payment offers, the period remaining before expiration of the statute of limitations for collection. *See* Form 656, *Offer In Compromise*, 6 (Rev. 7-2004).

[47] For example, the IRS generally does not levy on retirement plan assets unless the taxpayer's behavior has been "flagrant." IRM § 5.11.6.2 (Mar. 15, 2005).

[48] IRC § 72(t).

[49] SB/SE, Offer in Compromise Program, Executive Summary (FY 2006 through July).

because they cannot afford to pay 20 percent of the offer amount without any prior assurance that the IRS will accept the offer. Although I realize that Congress only recently enacted this provision, I think it is bad for taxpayers and could actually reduce revenue collection. I encourage Congress to revisit this requirement.

Responses to Questions from Senator Baucus:

Question 1:
Identify and discuss the five primary causes of the tax gap.

Response 1:
The IRS does not know the five primary causes of the tax gap. The IRS needs better research to determine why taxpayers do not comply and to then map such reasons back to the tax gap, so that it can figure out how to approach the problem most effectively.

At the risk of oversimplifying matters, let me suggest that we consider three types of taxpayers: (1) taxpayers who will go to great lengths to comply with whatever requirements exist; (2) taxpayers who view taxes as one of many burdens they face in everyday life and who will comply if doing so is straightforward and not time-consuming; and (3) taxpayers who willfully seek to evade their tax obligations.[50]

For each type of taxpayer, the IRS needs to know the reason for noncompliance to determine the optimal government response.

- For taxpayers who generally will go to great lengths to comply, the likely source of noncompliance is the complexity of the tax code. Thus, our approach should be to emphasize simpler laws and better explanations.

- For taxpayers who will comply if doing so is easy enough, our main emphasis should also be simpler laws and procedures, and better outreach and education. Here, though, we might also want to incorporate gentle enforcement action in our approach to try to persuade taxpayers that paying taxes must be a higher priority. In doing so, the IRS should incorporate taxpayer service *within* its enforcement actions. That is, at the same time that the IRS conducts audits or seeks to collect unpaid tax liabilities, the IRS should be courteous and should focus on trying to teach taxpayers how to avoid getting into trouble in the future. The IRS also

[50] Analysis has been conducted on types of noncompliance that is more detailed and subdivides taxpayers into narrower categories. *See* Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All,* 51 U. Kan. L. Rev. 1145 (2003).

must be careful to avoid creating noncompliance by imposing unrealistic procedural burdens on taxpayers who are trying to comply.

- For taxpayers who willfully seek to avoid paying taxes, enforcement is required – although even for these taxpayers, I think IRS employees generally should focus on trying to induce the taxpayers to comply prospectively.

Question 2:
To what extent is the IRS directing its resources toward the five primary causes of the tax gap? What measures are used to determine whether the IRS's efforts constitute the optimal use of resources to improve voluntary compliance and close the tax gap?

Response 2:
Because it does not know the indirect effect of its activities on compliance, the IRS does not know whether or not it is using its resources optimally to improve voluntary compliance and reduce the tax gap. Its most likely response is simply to focus more resources on the largest components of the tax gap as identified in the latest tax gap data.

The latest data from the National Research Program (NRP) indicates that 80 percent of the tax gap is attributable to underreporting of tax.[51] Most underreporting occurs with respect to transactions that are not subject to information reporting or withholding. Where taxable payments are reported to the IRS by third parties, the IRS generally collects well over 90 percent of the tax due.[52] Where taxable payments are not reported to the IRS by third parties, compliance drops precipitously, probably below 50 percent.[53] The IRS estimates the compliance rate for self-employed taxpayers who file a Schedule C is approximately 43 percent, resulting in underpayment of approximately $68 billion in income taxes alone.[54]

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[51] IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

[52] *See* IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

[53] *See* IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

[54] For purposes of my testimony, I used the term "cash economy" to mean all taxable payments that are not reported to the IRS by third parties. There is no universally agreed-upon definition of the term "cash economy." For a definition similar to mine, *see* Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate, 108th Cong. 21 (July 21, 2004) (statement of Professor Joseph L. Bankman defining the cash economy as "legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information reporting . . . your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting.").

Businesses operating in the cash economy may be responsible for more than a third of the tax gap. The IRS has no direct estimate of the portion of the tax gap attributable to the cash economy. However, according to IRS estimates:

- About 43 percent of the gross tax gap, or $148 billion a year, is attributable to underreporting of income and self employment taxes by self-employed individuals; and[55]
- Over 80 percent of all individual underreporting is attributable to understated income rather than overstated deductions.[56]

These estimates suggest that self-employed taxpayers who file returns but underreport their income (or self-employment) taxes represent the single largest component of the tax gap, accounting for more than a third of the gap and over $100 billion per year.[57] The IRS has begun to take steps to address noncompliance in the cash economy, but needs to take a closer look at many of the common-sense recommendations that I made in my 2004 Annual Report to Congress (ARC).[58]

Question 3:
Identify and discuss the five primary impediments to voluntary compliance.

Response 3:
Although it is difficult to identify five "primary" impediments to voluntary compliance, at least two important impediments are obvious: tax law complexity and the absence of information reporting or withholding requirements on certain types of income.

Complexity makes it difficult and expensive for taxpayers to determine how to comply with the law, makes it more difficult for the IRS to assist them, facilitates tax shelter schemes, and generates wasteful litigation and controversy. For these reasons, among others, the "Confounding Complexity of the Tax Code" is discussed in my 2004 ARC as the IRS's number one most serious problem.

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[55] Taxpayers who underreport business income on individual returns account for $109 billion of the gross tax gap and those who underreport self-employment taxes account for another $39 billion. IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

[56] *See* IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

[57] *See* IRS News Release, *IRS Updates Tax Gap Estimates,* IR-2006-28 (Feb. 14, 2006) (accompanying charts).

[58] See National Taxpayer Advocate 2004 Annual Report to Congress 211 (Most Serious Problem: IRS Examination Strategy); National Taxpayer Advocate 2005 Annual Report to Congress 55 (Most Serious Problem: The Cash Economy).

For slightly less obvious reasons, additional information reporting or withholding requirements could significantly improve voluntary compliance. As previously indicated, where payments are subject to withholding or information reporting, the reporting compliance rate is over 95 percent. Where there is little to no information reporting, compliance plummets dramatically to somewhere in the range of about 50 percent overall. This is hardly surprising. Where third parties report an item of income, taxpayers do not have to keep track of it themselves, and they know that the IRS knows about the income as well. Such information reporting reduces both the burden of keeping track of income and the temptation not to report it.

Question 4:
Identify and discuss the five primary burdens of taxpayers in meeting their tax obligations.

Response 4:
Five important tax burdens facing most taxpayers include:

- Recordkeeping;
- Understanding the law;
- Filling out tax forms;
- Paying (or pre-paying) taxes; and
- Communicating with the IRS.

Almost every taxpayer faces recordkeeping challenges. At a basic level, taxpayers need recordkeeping that is sufficient to help them keep track of their income and expenses so that they are in a position to fill out their income tax returns accurately at the end of the year. For business taxpayers, this burden is compounded by uncertainty about what level of documentation they require in order to claim various business expenses on their return. The deductibility of trade or business expenses has been one of the top 10 most litigated issues in recent years, and the taxpayer's level of documentation or recordkeeping is often at issue.[59]

As noted above, as the tax code becomes increasingly complex, understanding the law becomes more of a challenge for many taxpayers. Taxpayers need to understand the tax laws not only to arrange their affairs so as to act on the various tax incentives provided by Congress, but also to fill out their tax returns correctly and determine the amount of tax that they owe.

Not only are taxpayers expected to figure out how much they owe at the end of the year when they file their returns, but many taxpayers must also project at the beginning of the year how much they are likely to owe at the end of the year so

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[59] *See, e.g.*, National Taxpayer Advocate 2005 Annual Report to Congress 503 (Most Litigated Issue: Trade or Business Expenses).

that they make sufficient estimated tax payments and do not owe a lump sum that they cannot afford to pay at the end of the year. Especially for taxpayers who are subject to the alternative minimum tax, such projections are sometimes very difficult, if not impossible to make.

When taxpayers run into tax difficulties, they need to communicate with the IRS and the IRS needs to communicate with them. However, as the IRS tries to become more efficient, it often relies more heavily on notices, form letters, and centralized processing operations. Some taxpayers find IRS notices and letters confusing.[60] In addition, the IRS's centralized processing operations are not always as effective in communicating with taxpayers as we would like them to be.[61] The IRS faces the challenge of figuring out how to provide the right level of service to all taxpayers to assist them in complying with an increasingly complex set of tax rules, notwithstanding increasing levels of complexity.

Question 5:
Identify and discuss the five primary concerns of IRS external stakeholders.

Response 5:
The Taxpayer Advocate Service (TAS) has not conducted any statistically valid surveys of external stakeholders to determine their concerns with scientific precision. However, because we take external stakeholders concerns into account as I prepare my annual reports to Congress, we believe that our concerns align with the concerns of many taxpayers and external stakeholders. In general, we believe that external stakeholders care about taxpayer burden, fairness of the law and the IRS, taxpayer rights, and the tax gap.

Question 6:
Identify and discuss the five most significant impediments to the IRS's efficiency and effectiveness. What is the IRS doing to eliminate or mitigate these impediments?

Response 6:
Some potential impediments to the IRS's efficiency and effectiveness include:

Tax law complexity: As complexity of the tax code increases, it becomes increasingly difficult to administer. IRS processes have to become more

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[60] *See, e.g.*, National Taxpayer Advocate 2004 Annual Report to Congress 163 (Most Serious Problem: Lack of Notice Clarity).

[61] *See, e.g.*, National Taxpayer Advocate 2005 Annual Report to Congress 1 (Most Serious Problem: Trends In Customer Service); National Taxpayer Advocate 2004 Annual Report to Congress 311 (Most Serious Problem: Offers In Compromise) (discussing difficulties encountered by the IRS's campus operations in communicating with taxpayers regarding offers); National Taxpayer Advocate 2005 Annual Report to Congress 326 (Most Serious Problem: Innocent Spouse Claims)(discussing difficulties encountered by the IRS's campus operations in communicating with taxpayers regarding innocent spouse claims).

complex, and its employees need more training and have more difficulty explaining what taxpayers need to do to comply. Such complexity can only reduce the IRS's efficiency and effectiveness.

Research, Strategic Planning, and Information: As previously indicated, the IRS does not know the indirect effects of its compliance activities or the causes of noncompliance and does not have up-to-date information about the components of the tax gap. The IRS often focuses only on the direct revenue generated by an activity because it lacks such information. Because enforcement generates direct revenue and customer service does not, this approach will lead to the erroneous conclusion that resources are always more effectively spent on enforcement than on customer service or outreach. Such limited thinking reduces the IRS's ability to reduce the tax gap efficiently and effectively.

Another impediment to the IRS's efficiency and effectiveness is its failure to take strategic and programmatic approaches to issues. For example, the IRS has not established a Cash Economy Program Office as recommended in my 2005 Annual Report to Congress despite the fact that NRP tax gap estimates suggest there is significant noncompliance in the cash economy.[62]

The IRS's efficiency and effectiveness are also hampered by the fact that the IRS does not get as much information (*e.g.*, sales tax, gross receipts, etc.) as it could from the states.

Training: One way to mitigate the effect of tax law complexity on IRS efficiency and effectiveness would be to provide more high quality training to IRS employees. Thus, a failure to increase the amount of high quality training provided to IRS employees could, in some cases, represent an impediment to efficiency and effectiveness. It is difficult to evaluate the efficiency or effectiveness of IRS training.[63] This is an area that may require further analysis.

Brain Drain: The IRS depends on the expertise of its employees. According to projections by the IRS Oversight Board, about 25 percent are eligible to retire this year.[64] The rapid loss of such valuable experience, expertise, and institutional knowledge would present serious challenges to the IRS's ability to be efficient and effective. The IRS's strategic plan says that it will sustain aggressive

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[62] *See* National Taxpayer Advocate 2005 Annual Report to Congress 73. *See also* National Taxpayer Advocate 2007 Annual Report to Congress, Volume II, at 13.

[63] *See generally* Treasury Inspector General for Tax Administration, Ref. No. 2003-10-212, *Information on Employee Training Is Not Adequate to Determine Training Cost or Effectiveness* (Sept. 2003).

[64] *See* IRS Oversight Board Annual Report 2004, 21-22, *available at* http://www.treas.gov/irsob/documents/2004_annual_report.pdf.

recruitment, provide additional training, and leverage its resources through the use of technology to mitigate the loss of experienced personnel.[65]

Business system modernization: The IRS still relies on a forty-year-old information system for its "master file" recording-keeping functions, which can only be updated on a weekly basis. Updating the IRS's antique technology would go a long way towards making the IRS more efficient and effective.

Question 7:
Identify and discuss the five most significant resource challenges facing the IRS.

Response 7:
The challenges to the IRS's efficiency and effectiveness, discussed above in Response 6, also represent resource challenges.

Question 8:
Identify and discuss the five primary impediments to delivering top quality customer service.

Response 8:
In general, the challenges to IRS efficiency and effectiveness, discussed above in Response 6, also represent impediments to delivering top quality customer service. I provide a more detailed discussion of some of the challenges that the IRS faces in delivering top quality customer service in my annual reports to Congress.[66]

Question 9:
Identify and discuss the five primary technological impediments the IRS is experiencing.

Response 9:
Although the "master file" example, discussed above, is an important example of the IRS's technological impediments, it is difficult to list or rank all of the ways that technological limitations affect the IRS. When I was in private practice as an attorney representing clients before the IRS, I did not have a full appreciation of how significant a role Business Systems Modernization (BSM) plays in both creating and solving problems for taxpayers and the IRS. As the National Taxpayer Advocate, I know that on a regular basis my office identifies systemic problems for which the complete solution requires some sort of BSM fix.

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[65] *See* IRS Strategic Plan 2005-2009, 27.

[66] *See, e.g.*, National Taxpayer Advocate 2005 Annual Report to Congress 2 (Most Serious Problem: Trends in Taxpayer Service); National Taxpayer Advocate 2004 Annual Report to Congress 8, 26, 43, 51, 132, 163 (Most Serious Problems entitled: Taxpayer Access: Face to Face Interaction, Taxpayer Access: Remote Interaction, Accuracy of Tax Law and Accounts Assistance, Education and Outreach Issues, Inconsistent Campus Procedures, Lack of Notice Clarity).

When Commissioner Everson began his tenure, he ordered three separate reviews – two external, one internal – of the state of IRS BSM projects. Based on these reviews, the Commissioner quickly – and, I believe, correctly – concluded that the IRS was spreading its internal BSM resources too thin. Project managers and experts charged with overseeing our key initiatives – such as the Integrated Financial System (IFS) and the Customer Account Data Engine (CADE) – were also managing scores of smaller projects, all more or less important but all detracting from our central progress on IFS and CADE.

For the past three years, the IRS has focused on its primary projects and strictly controlled the number of other BSM projects. This approach makes sense because it is critical to both effective service and enforcement that the IRS move forward with its primary initiatives. On the other hand, many projects cannot be deferred too much longer without significantly impacting taxpayer rights, accuracy of taxpayer data, and effective examination and collection initiatives. Indeed, improvements to TAS's own Systemic Advocacy Management System, our database for receiving, tracking, and managing taxpayer and IRS employee submissions of systemic problems in tax administration, were requested in November 2004. Although worked on intermittently, these changes have not yet been completed or delivered. Until recently, this project was ranked number 33 on a list of 33 projects in terms of priority.

I will provide one illustration of the impact of the IRS's outdated computer systems. In my 2004 ARC, I reported that the IRS is miscalculating collection statute expiration dates on certain taxpayer accounts. The collection statute expiration date (CSED) represents the date beyond which the taxpayer is no longer obligated on a tax debt and the IRS must cease its collection efforts.[67] Miscalculations of CSEDs can negatively affect a taxpayer when the CSED on a particular tax erroneously appears on the IRS computer systems as being within the statute of limitations period, resulting in continued IRS collection activity, when in fact the statutory period for collections has expired. An incorrectly calculated CSED can also negatively impact the IRS when the CSED is miscalculated to reflect that the statute of limitations period has expired when in fact the debt is still collectible.[68] This problem continues today and harms tens of thousands of unsuspecting taxpayers. Where the IRS or the taxpayer identifies a case of unlawful collection, the taxpayer experiences delays in receiving a return of the unlawfully levied proceeds. In some instances, the IRS takes the position that the taxpayer will never receive the unlawfully levied funds because the refund is barred by the applicable statutory period of limitations.

In response to TAS's concerns, the IRS and TAS established a joint team that identified impacted taxpayers, developed additional guidance and training alerts,

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[67] IRC § 6502(a)(1).

[68] National Taxpayer Advocate 2004 Annual Report to Congress 180-192.

and submitted requests for systems improvements to eliminate the problem of incorrectly calculated CSEDs. Given the current demand on IRS programming personnel, the final system modifications are not now scheduled to occur until *some time in 2007*.

Internal Revenue Code §7433 permits a taxpayer to file a civil action for damages against the United States in federal district court where an IRS officer or employee disregards any provision of the Code or its regulations with respect to collection of tax. In general, damages under this provision are limited to $1 million where the breach is attributable to reckless or intentional disregard and $100,000 where it is attributable to negligence. Thus, the IRS's knowing failure to correct the CSED problem in a timely fashion exposes the government to potentially large damages.

Question 10:
Identify and discuss the five primary collection impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?

Response 10:
As discussed in the 2004 and 2006 ARCs, perhaps the most significant impediment facing the IRS collection program is the adherence to a collection strategy that has basically remained the same for decades. In my report, I identified several essential elements for a collection strategy that would balance the goals of tax collection, taxpayer service, and tax compliance. These elements included the need for prompt human contact with delinquent taxpayers, understanding the reasons for their noncompliance, and identifying the appropriate collection treatment for each taxpayer based on his or her individual characteristics and needs. In order to be truly effective, the IRS needs to embrace the concept that tax collection, one of the most visible components of IRS efforts to enforce the tax laws, is most effective when conducted in a "service-oriented" manner. Ask an IRS collection manager today what is meant by "enforcement" of the tax laws, and you will likely hear a reply that discusses federal tax liens, levies, and property seizures. While these actions are certainly IRS enforcement tools, so are clearly written collection notices, timely personal contacts by collection personnel, installment agreements, and offers in compromise (OIC). In addition to the collection of delinquent tax dollars, a primary goal of the IRS is to convert delinquent taxpayers into compliant taxpayers. I believe that both goals can be most effectively achieved with a service-oriented collection strategy that recognizes that most collection accounts involve financially challenged taxpayers who require assistance in resolving their tax debts. Within this context, we offer the following as significant impediments to attaining these goals.

1. Early Intervention – Much more emphasis is needed on the importance of initiating timely, meaningful contacts in IRS collection cases. Standard business

practices routinely acknowledge that the collectibility of delinquent accounts receivable rapidly diminishes with age. The traditional case assignment practices that have been used by the IRS for years are inefficient and ineffective, and underplay the importance of age in the collection of delinquent accounts. As a result, the government is losing billions of dollars in revenue each year, and many taxpayers must live with unresolved financial problems for extended periods of time.

2. "Problem-Solving" Case Resolutions – Much more emphasis is needed in the IRS collection strategy on resolving collection cases in a manner that provides resolution and closure to taxpayers in a reasonable and timely manner. The IRS has available a wide variety of collection payment options that can be employed to assist taxpayers in resolving their tax debt problems. Historically, the IRS has been very reluctant to use collection payment alternatives, such as offers in compromise and partial payment installment agreements, even in situations where the accounts will otherwise be reported as uncollectible. Yet, an analysis of IRS collection results reveals that in FY 2005, more delinquent tax dollars were reported as "currently not collectible" (CNC) than were actually collected on open Taxpayer Delinquency Accounts (TDAs) and installment agreement accounts combined. Historically, the IRS has annually recovered approximately one percent of the revenue dollars reported as CNC. Obviously, the "passive collection" approach, i.e. report the account as CNC and wait for something good to happen, is not an effective revenue producing strategy. Moreover, it completely ignores the negative impact on the taxpayers, who must continue to live with the financial consequences of the unresolved tax debts.

3. Taxpayer-Focused Collection Goals and Measures – There is an old management axiom that states "those things that get measured are the things that get done." In regard to the concerns already discussed in the areas of Early Intervention and Problem-Solving Case Resolutions, current IRS collection measures are woefully inadequate. For example, the true age of a delinquent tax debt should be based on the due date of the applicable tax return. From the taxpayer's perspective, the unpaid account is delinquent the day after the return is due. The IRS routinely measures the age of its delinquent accounts receivable by the length of time the account spends within a specific phase of the collecting process, *i.e.*, the Automated Collection System, Collection Field function, OIC, etc. For example, a collection case involving the 1996 tax year is not considered "overaged" if it has just been assigned to the Collection Field function within the past year. Yet, from the taxpayer's point of view, this account is very old and likely to be uncollectible. The IRS measures its success in improving revenue collections by comparing the current year's dollars collected to prior years. However, this approach completely ignores the matter of lost revenue, *i.e.*, dollars reported as uncollectible, abatements, etc. This approach provides no incentive to the IRS to provide payment solutions to taxpayers who cannot immediately arrange for the full payment of the outstanding tax debt and actually promotes the use of the "passive collection" philosophy. IRS collection quality

review measures generally track the degree to which IRS employees adhere to established Internal Revenue Manual (IRM) procedures, but provide very little insight to how well these procedures meet taxpayer needs and expectations. Without measures that accurately reflect these needs and expectations, efforts by the IRS to improve its collection operations will likely meet with limited success.

I suggest the following measures as examples for your consideration:

"True Age" of Accounts Receivable – the IRS should measure and track the age of delinquent tax accounts based of the due dates of the applicable returns. This measure would provide a much more accurate measure regarding the timely resolution of IRS collection cases and also provide a more realistic basis for the use of collection payment alternatives.

"Net Revenue Collected" – the IRS should measure and track revenue dollars collected minus dollars reported as not collectible and revenue dollars abated, i.e., net revenue = dollars collected – (dollars reported as CNC + dollars abated). This measure would provide a more accurate assessment of the overall effectiveness of the IRS collection program, as well as promote case dispositions that provide resolution and closure to the taxpayers.

4. Collection Resources (Staffing & Training) – In order to be effective, the IRS must be equipped with a sufficient number of highly qualified, well-trained collection employees. I am aware that in recent years budgetary concerns have contributed to government-wide restrictions on hiring. At the agency and department levels, restricted budgets invariably lead to reductions in training. However, even in challenging economic times, investments in the IRS collection program more than pay for themselves. Adequate training is absolutely essential to ensure that IRS employees make sound, well-reasoned case decisions and provide high-quality service to America's taxpayers. Additionally, the IRS needs to employ a new strategy to determine realistic needs for the right number, of the right types, of collection employees, utilized in the right locations. Hiring restrictions in recent years (actually well over a decade!) have contributed to much more emphasis on centralization and the use of lower-graded employees to provide service on IRS collection accounts. With proper hiring standards and first-class training, this approach may be warranted in some areas. For example, collection accounts involving first-time delinquents and relatively small balances due can be handled very effectively through correspondence or over the phone. However, cases involving employment tax delinquencies and situations requiring the use of more complex collection treatments, such as offers in compromise, insolvencies, etc., may require face-to-face interactions with well-trained, specialized field employees. Unfortunately, feedback from external stakeholders has consistently indicated that centralization has been more driven by cost-reduction efforts, with less than adequate emphasis on hiring standards and

proper training. If this feedback is indicative of an emerging trend, the IRS collection program will suffer for years to come.

5. Collection Resources (Automation Support) -- Much has already been said about the IRS's antiquated computer system. Generally, most parties seem to agree that the modernization of the IRS's automation systems must be accomplished in order for the IRS to effectively handle its mission in the future. However, I have noted that improvements in modernizing automation systems that support the IRS's collection operation have been exceptionally slow in coming and do not appear to be doing much more than migrating existing legacy programs to a new operating environment. Currently, the systems supporting the IRS collection program represent separate portions of the collecting process, *i.e.* ACS, the Collection Field operation, OIC, etc. In order to provide efficient, seamless taxpayer service on collection accounts, these components need to be integrated into one, easily managed database. Collection employees should have more comprehensive real-time access to taxpayer accounts. The collection automation support system should also provide collection managers with the information and measures needed to make informed program decisions.

Question 11:
Identify and discuss the five primary examination impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?

Response 11:
In general, the challenges discussed in response to question 6, above, also impede the IRS examination process. The following discussion highlights a few of those items and challenges that are specific to examinations.

Obsolete computer systems: The IRS submits numerous requests each year for changes to computer program applications that will enhance the examination process. Unfortunately, most of these requests never reach the end stage due to the tremendous backlog of requests and established priorities. In order for the IRS to effectively address noncompliance in an era of electronic media, it must be equipped with resources to promptly respond to requests for new and revised computer applications.

Noncompliance resulting from tax law complexity: The examination function could spend more time focusing on taxpayers who refuse to comply with the tax laws if the tax laws were simpler. For example, countless IRS employees conduct examinations of taxpayers who do not understand the Earned Income Tax Credit (EITC) rules. Many of these taxpayers want to comply but are not tax savvy enough to piece together all the rules and exceptions. Tax laws must mirror the taxpayers to which they apply in order to reduce the need for examinations.

Opportunities for noncompliance in the cash economy: As noted above, studies have shown that taxpayers who are subject to withholding are highly compliant. The highest rate of noncompliance is with business owners, particularly those who own cash businesses or do not receive information reporting documents at year-end. In my 2005 ARC, I set forth a number of common sense proposals that would reduce the opportunities for noncompliance in the cash economy and reduce the need for examinations.[69] For example, one such proposal would provide that payors be required to institute backup withholding on payments subject to information reporting (*i.e.*, non-employee compensation in excess of $600 paid in the course of a trade or business) to independent contractors specifically identified by the IRS as "substantially noncompliant."[70] The term "substantially noncompliant" would be defined by regulations. Generally, only contractors who had recently failed to pay income tax or self-employment tax liabilities on more than one occasion would be deemed substantially noncompliant. Backup withholding would be ceased when the IRS deems a contractor "substantially compliant." A contractor would be deemed "substantially compliant" if, for example, the contractor scheduled a year's worth of estimated tax payments through EFTPS or entered into an installment agreement or voluntary withholding agreement.

Selecting the right type of exam for a given issue and a given taxpayer: The IRS has been using more and more correspondence examinations in lieu of field or office examinations.[71] Because correspondence examinations are conducted by mail and typically address only a single issue which is often an information reporting discrepancy, they are quicker and less expensive than other types of examinations. Correspondence examinations, however, are not the most effective way of examining every taxpayer. For example, they are probably not an effective way of examining taxpayers who can not read and write.

In addition, correspondence examinations are not an effective way to detect unreported income from the cash economy. In contrast to Correspondence Examiners, the Revenue Agents and Tax Compliance Officers who conduct field and office examinations, respectively, are not limited to a single issue and will change their focus in response to new information.[72] This approach allows agents to find unreported income that a limited-scope correspondence examination would not detect. For example, Revenue Agents are supposed to conduct certain "filing checks" to ensure that taxpayers have filed all of their

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[69] *See* National Taxpayer Advocate 2005 Annual Report to Congress 381 (Key Legislative Recommendation: Measures to Reduce Noncompliance in the Cash Economy).

[70] National Taxpayer Advocate, 2005 Annual Report to Congress 383-389; National Taxpayer Advocate, 2007 Annual Report to Congress 498-500.

[71] *See generally*, Treasury Inspector General Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May be Limited* (July 25, 2006).

[72] IRM § 4.10.4.1(2) (June 1, 2004).

returns, including information returns.[73] These checks may lead to an expansion of the audit to include additional years or other taxpayers, which can uncover unreported income.[74] Revenue Agents can also use more sophisticated methods to detect unreported income. For example, they can observe the taxpayer's business operation.[75]

The IRS's over-reliance on correspondence examinations and information reporting may reinforce the belief held by some cash economy participants that only income subject to information reporting is subject to tax.[76] Such perception may result from the fact that the IRS is unlikely to detect underreported income unless it is subject to information reporting. Thus, the IRS needs to do more research to make sure that it is using correspondence examinations effectively.

The IRS does not use research regarding the "indirect effect" of an examination to determine which type of examination to use and which taxpayers and issues to examine. Because studies have concluded that examinations reduce the tax gap primarily through an indirect effect on voluntary compliance, the IRS needs to research such effects to determine how to allocate examination resources most effectively.[77]

Legislation could perhaps prompt the IRS to initiate such research. Legislation to simplify the tax code would also make tax administration easier, including examinations. In addition, increased information withholding would increase visibility, but would also require legislation.

Question 12:
To what extent will the high percentage of retirement-eligible employees at the IRS impact the tax gap within the next five years? 10 years?

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[73] IRM § 4.10.5 (July 31, 2001). We have not analyzed how often such filing checks actually occur.

[74] *See* IRM § 4.10.5 (May 14, 1999).

[75] IRM § 4.10.4 (June 1, 2004); IRM § 4.10.4.3.5 (June 1, 2004). Similarly, when a Revenue Officer (*i.e.*, IRS collection personnel working in the field) files a substitute for return for a high income nonfiler, he or she is required to observe the taxpayer to determine if sufficient income is reflected on the information reporting documents before filing the substitute for return. *See* IRM § 5.1.11.6.3.1 (May 5, 2003).

[76] One IRS focus group found that "[P]ractitioners say cash businesses are wide open for tax cheating. 'Cash doesn't count' is what many of their clients think." SB/SE Research – Brooklyn/Hartford, Project 01.08.003.04, *TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups* 9 (Dec. 2004).

[77] For example, even after IRS issues a notice of intent to levy on federal payments, the GAO has estimated that 73 cents out of every dollar that is collected is paid voluntarily, rather than by levy. General Accounting Office, *Federal Payment Levy Program Measures, Performance, and Equity Can Be Improved*, GAO-03-356, 6-8 (March 2003).

Response 12:
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 13:
What is the IRS doing to retain experienced employees eligible for retirement?

Response 13:
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 14:
Describe the IRS's plans to transfer knowledge, skills and abilities from experienced workers to new workers, and to hire workers to replace employees who retire.

Response 14:
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 15:
The Committee has requested Treasury and the IRS to submit a credible, comprehensive plan by September 30, 2006 to close the tax gap

a. To what extent will having a tax gap plan help to close the gap?
b. Are Treasury and the IRS capable of developing a credible and comprehensive plan by September 30, 2006?
c. Describe what such a plan should look like, for example, what priorities, goals, benchmarks and measures do you think should be included in a tax gap plan? Discuss the appropriate allocation of resources among service, enforcement and technology as part of your response.
d. To what extent can existing IRS strategic and action plans regularly prepared by operating divisions and other functions be used toward developing a comprehensive tax gap plan?
e. To what extent can recommendations from the IRS Oversight Board, the National Taxpayer Advocate, the Government Accountability Office, the Treasury Inspector General for Tax Administration, the National Treasury Employees Union and non-governmental stakeholders be used toward developing a comprehensive tax gap plan?

Response 15:
At the time of this writing, the United States Department of Treasury, Office of Tax Policy, has already released its comprehensive plan to close the tax gap. See *A Comprehensive Strategy for Reducing the Tax Gap* (September 26, 2006).[78]

Question 16:
Please provide the results of the most recent "TIPS" (Trends, Issues, Problems) reports for each IRS operating division and major function.

Response 16:
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 17:
Please provide the most recent Strategic Action Plans for each IRS operating division and major function.

Response 17:
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 18:
Provide examples of instances when the Treasury and the IRS have developed plans in response to unanticipated circumstances or legislation containing effective dates very soon after the date of enactment.

Response 18:
The IRS has demonstrated its ability to expeditiously and effectively respond to unanticipated events.

From a contingency planning perspective, the IRS develops *Disaster Recovery Plans* that document the systems, telecommunication requirements, strategies, personnel, procedures, and resources that the IT and Telecommunications Recovery Teams will need in response to a short or long term interruption. At the business unit level, as part of a comprehensive strategy, each unit develops its own unique *Business Resumption* requirements for how it will resume operations in the event of an interruption to normal processes.

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[78] Department of the Treasury, *A Comprehensive Strategy for Reducing the Tax Gap* (September 2006).

Unanticipated Event – Flood at IR Building at 1111 Constitution Ave, Wash., DC

On June 26, 2006, a flood at the Main IR Building at 1111 Constitution Ave, Washington DC, displaced approximately 2,241 employees, over one thousand of which were involved in critical business processes. The Incident Management Team (IMT) was activated to implement the business resumption plans. By July 5, the IMT and Real Estate and Facilities Management (REFM) personnel had placed all critical employees that required work space thereby ensuring no interruption of services to taxpayers. The IMT and REFM teams subsequently placed over one thousand *non-critical* employees in temporary work space. This action was completed by August 1, 2006.

Legislative and IRS Based Relief in Response to Unanticipated Events

In the aftermath of the 2005 Gulf Hurricanes, legislative actions were initiated and IRS relief granted emergency relief.

- Katrina Emergency Tax Relief Act of 2005, P.L. 109-73, 09/23/05
- Gulf Opportunity Zone Act of 2005, P.L. 109-35, 12/21/05
- IRS Publication 4492 (01/2006), Information for Taxpayers Affected by Hurricanes Katrina, Rita and Wilma

IRS Granted Relief

Notice 2006-56 (Hurricane Katrina)
Notice 2006-20 (Hurricane Katrina)
Notice 2005-81 (Hurricane Katrina)
Notice 2005-82 (Hurricane Rita)
Notice 2005-73 (Hurricane Katrina)
IR News Release IR 2005-110 (Hurricane Rita
IR News Release IR 2005-128 (Hurricane Wilma)

Acts Postponed for Affected Taxpayers or Other Relief Granted

- Filing any return of income, estate, gift, generation-skipping transfer, excise, or employment tax;
- Paying any income, estate, gift, generation-skipping transfer, excise, or employment tax, including making estimated tax payments;
- Making certain contributions, distributions, or rollovers to or from a qualified retirement plan;
- Filing petitions with the Tax Court;
- Filing a claim for credit or refund of any tax; and
- Bringing suit upon a claim for credit or refund.

Also, the recently enacted Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) included several significant changes to the IRS OIC program, including requirements for taxpayers to submit partial payments with OIC

applications. Under the new law, taxpayers submitting requests for lump-sum OICs must include a non-refundable payment equal to 20 percent of the offer amount. Taxpayers submitting requests for periodic-payment OICs must include the first proposed installment payment with their application and maintain the proposed payment schedule while the offer is being evaluated by the IRS. Under the new law, taxpayers qualifying as low-income qualify for a waiver of the new partial payment requirements. The IRS was given only 30 days after the enactment of TIPRA to implement these changes. While it appears that the intent of Congress in passing this legislation was for the IRS to make more and better use of the OIC as a revenue-generating collection tool, the likely unintended consequences of these changes could be a substantial reduction in the number of OICs submitted to the IRS for consideration. Particularly in regard to lump-sum OICs, we believe the new partial payment requirements will impose unrealistic expectations on many taxpayers, who already may be struggling to secure sufficient funds for an offer the IRS will deem as acceptable. The exceptionally short timeframe for implementing the TIPRA changes provided very little opportunity for the TAS to work with the IRS on strategies to mitigate these concerns.

Question 19:
To what extent do delays in issuing regulations or other guidance, or delays in deciding a legal position on an issue, impact the tax gap? Comment on the appropriate nexus between expedient tax administration and the "right" legal answer to a tax issue, e.g., is it preferable to issue guidance more quickly that meets the needs of 99% of taxpayers rather than deferring guidance for an extended time in order to address the remaining 1% of taxpayers with unique or unusual circumstances?

Response 19:
It may very well be impossible for the IRS to estimate the exact extent to which a lack of clear guidance affects the tax gap. However, while serving as IRS Chief Counsel, John B. Williams wrote:

> *A system of self-assessment, such as ours, requires the IRS to issue guidance to assist taxpayers in determining what works and what does not....We have a public duty to provide timely guidance to taxpayers who are trying to comply with the law. Treasury and the Office of Chief Counsel are committed to early and joint review to increase the level of published guidance. Issuing guidance quickly requires us to develop our principal position and announce it rather than attempting to refine all the possible arguments. Too often published guidance is delayed while we attempt to formulate the perfect solution to all potential problems. We should focus instead on excellent advice that covers the general issues. More specific problems that may arise can be addressed in later guidance.*

> *The Chief Counsel's office cannot function as an academic institution. Our role is to issue guidance that addresses the major issues as soon as possible so the public and the field are aware of the positions of the agency. That guidance must be in a form that is reliable.* -- Statement of B. John Williams Before the 52nd Midyear Conference on March 19, 2002 published in The Tax Executive March-April 2002.

Taxpayers are likely to have difficulty complying with the law if they do not know what the law requires, or they may feel like chumps if they do not interpret it in the manner most favorable to themselves when the IRS has been silent and they believe that their competitors are doing the same. Thus, if the goal is to help most taxpayers comply without feeling like chumps, then quickly promulgating generally applicable guidance should be a higher priority than waiting to develop perfect guidance that works for everyone.

In our rush to promulgate guidance of general applicability, however, we must be sure to go back and fix any problems that we create for other taxpayers who fall outside the norm. To the extent that the fairness of the tax system affects voluntary compliance, guidance that is unfair to or creates loopholes for a minority of taxpayers could erode voluntary compliance.

Question 20:
The National Taxpayer Advocate testified that examiners participating in the IRS's National Research Program reported that only 3% of the issues resulting in a change in tax liability were the result of "deliberate or intentional" acts, 27% of adjusted issues were identified as computational errors, and 67% were reported to be inadvertent mistakes.

a. To what extent are the examiners' figures reliable?
b. Dr. Mazur and Mr. Brostek commented that it was difficult to tell whether errors that studies had classified as simple mistakes were truly inadvertent. Please provide examples of studies that demonstrate this point.
c. What factors could influence an examiner's characterization of the causes of an adjustment to an issue?
d. What training do examiners receive to identify and characterize the causes of noncompliance?
e. For purposes of the NRP study, provide the definitions of deliberate, intentional, and inadvertent.
f. Please provide an example of the document completed by examiners that contains this information.
g. To what extent is an examiner required to consider penalties if he/she characterizes the cause of an adjustment to be the result of a deliberate or intentional act?

Response 20:
It is often difficult to discern the true intent of a taxpayer during the course of an audit. Sometimes, however, based on the facts and circumstances uncovered during the course of the examination, the intent is clear. It should be possible, therefore, to design specific guidelines identifying cases where the error was inadvertent and other cases where the noncompliance was deliberate. For the remaining cases, it is probably best not to guess at the taxpayer's intent and to classify them in a neutral or unknown category.

I believe that examiners could be trained in this approach, and could accurately classify cases into one of these three categories during the next NRP. Such an approach would give the examiners the leeway to classify intent as unknown where appropriate and avoid assessment of penalties except in cases where the examiner was confident of the taxpayer's intent.

Examiners did not have this leeway during the last NRP, and consequently the accuracy of their classification decisions may be problematic. The magnitude of the inadvertent and math error categories, does strongly suggest, however, that many taxpayers, perhaps the majority, were not intentionally noncompliant.

Question 21:
Please provide a current list of all information returns that are matched to tax returns submitted to the IRS for the purpose of detecting unreported income. Identify additional information returns that will begin to be matched within the next 12 months.

Response 21:
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 22:
The National Taxpayer Advocate, the GAO and others have recommended a basis reporting regime to reduce noncompliance resulting from incorrectly stated basis amounts.

Question 22 (a):
Does the IRS have the ability to match basis amounts reported on an information return with basis amounts reported on a tax return?

Response 22 (a):
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 22 (b):
If the IRS lacks the ability to match basis information, provide the reasons why. Explain what actions are necessary to make such matching possible and how quickly this can be accomplished.

Response 22 (b):
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 23:
Dr. Mazur estimated that 7 million immigrants are on U.S. payrolls, and 75% of them pay employment taxes. Dr. Mazur indicated that the number of these individuals using stolen or false social security numbers is unknown.

Question 23 (a):
IRS Publication 4535 advises individuals to respond immediately to an IRS notice in the event of a tax matter resulting from identity theft. Describe the actions taken by IRS officials when the IRS is notified by an individual that his/her identity has been stolen, resulting in a tax matter. Provide applicable Internal Revenue Manual sections or other internal guidance describing these procedures.

Response 23 (a)
When a taxpayer tells a case advocate with TAS that his or her identity might have been stolen or used by another person, the case advocate must take certain steps to resolve the case based on the taxpayer's facts and circumstances. TAS case advocates will follow IRS procedures that apply to each situation listed below.

1. **There is no indication that there was inappropriate use of the stolen identity for IRS tax purposes**

   If a taxpayer reports that his or her identity has been stolen, but has no knowledge that the stolen identity has been used inappropriately for tax purposes (meaning there has been no IRS notification), the TAS employee reviews the taxpayer's files to confirm that there is no indication that the taxpayer's stolen identity has been used for tax purposes. When there is no indication, then the TAS employee advises the taxpayer to contact the Federal Trade Commission (FTC) at (877) 438-4338 to complete an Identity Theft Affidavit. The taxpayer is also advised that the form is obtainable by visiting the FTC website located at www.FTC.gov. IRM 21.1.3.24, SSN Misuse and/or Identity Theft, also states that when a taxpayer is requesting a new or replacement SSN or a "posted earnings" determinations, to refer the taxpayer to the Social Security Administration (SSA), at 1-800-772-1213.

2. **There is indication that there was inappropriate use of the stolen identity for IRS tax purposes**

   If a taxpayer reports that his or her identity has been stolen, the TAS case advocate follows IRM procedures to have adjustments made to remove or to reverse assessments against the taxpayers based on stolen identities. For certain adjustments, the IRS requires certain documentation. In the September 2006 revision of IRM 4.19.3, IMF Automated Underreporter, section 4.19.3.20.1.23, Stolen Identity, states that:

   > Acceptable documentation includes BUT is not restricted to any of the following:
   >
   > - Copy of a police report;
   > - FTC Identity Theft Affidavit;
   > - Correspondence to or from financial institutions, employers or Social Security Administration; and
   > - A signed statement/explanation – take into consideration the timing of the taxpayer's awareness that his Social Security Number (SSN) is/was being used by someone else, the business conducted by the payer and the taxpayers occupation, the source and type of income reported on the return, and the address or location of the payer in comparison to the taxpayers address or commuting area.

   In these situations and others, the taxpayer may benefit from contacting the FTC as mentioned above.

   For certain adjustments, the case advocate must use Form 12412, Operations Assistance Request (OAR), to request the appropriate IRS unit do the adjustment per IRM 13.1.7.7, Operations Assistance Request (OAR) Process.

3. **Notification of underreported income sent to the taxpayer, when the taxpayer's SSN is used by another person**

   The taxpayer receives a CP-2000, Notice of Proposed Adjustment for Underpayment/Overpayment. The CP 2000 is sent to the taxpayer to propose a change to income tax liability because of income that is not identified or does not appear to be fully reported on the tax return. This may be based on based on Form W-2, Wage and Tax Statement. This situation may not be an indication of stolen identity since it is possible for an incorrect SSN to be entered on a document sent to the IRS such as the W-2.

   The case advocate follows procedures in IRM 4.19.3, IMF Automated Underreporter, and in IRM 13.1.4.2.3.11, Underreporter Program (URP) Assessment. The case advocate must use Form 12412, Operations

Assistance Request (OAR), to request that the appropriate IRS unit make the adjustment. Please refer to IRM 13.1.7.7, Operations Assistance Request (OAR) Process.

4. Indication that two or more returns are filed by more than one person and the true owner of the SSN can be identified (a mixed entity issue)

Per IRM 21.6.2.4.2, Multiple Individuals Using the Same TIN, cases involving multiple taxpayers using the same SSN are classified as a mixed entity or scrambled SSN case. As the case is developed, the IRM procedures that the case advocate will use depend on what the case advocate finds in researching IRS files, the responses or lack of responses received from the taxpayers, and on responses received from other government agencies, such as the SSA. Preliminary research must be completed before the case can be accurately identified as a mixed entity or scrambled SSN case.

A mixed entity case is created when two taxpayers file a return with the same SSN for the same tax period and the owner of the SSN can be identified. This situation may not be an indication of stolen identity since it is possible for an SSN to be entered incorrectly on a return and it happens to match the taxpayer's SSN. This error can be caused by a taxpayer, a return preparer, or a processing error.

If the duplicate filing was caused by identity theft, normally a valid SSN cannot be found for one of the taxpayers, but research can determine that the other taxpayer is the true owner of the SSN that was used to file both returns.

The case advocate follows IRM 21.6.2.4.2.2, Preliminary Research, to locate the correct SSN for each taxpayer without requesting information from the taxpayers.

IRM 21.6.2.4.2.3, Case History Sheet, requires that:

> Forms 13708, 13708A, 13708B, and/or 13708C, Mixed Entity/Scrambled SSN Case History Sheet, are required when working cases involving multiple individuals using the same SSN. All account actions, taxpayer contact and SSA contact must be included on the history sheet.

When the correct SSN is located, the case advocate follows procedures in IRM 21.6.2.4.3, Mixed Entity Procedures, to make the appropriate adjustments.

Per IRM 21.6.2.4.2.2, Preliminary Research, when the case advocate cannot locate the correct SSN, the case advocate sends each taxpayer a 239C Letter, Scrambled SSN Clarification to Taxpayer. The letter asks the taxpayer

to answer a questionnaire and to provide documentation of his or her identity. Acceptable identification may include copies of a driver's license, a social security card, a birth certificate, copies of filed tax returns, and signature samples. The case advocate may contact third parties for additional verification.

Response(s) or lack of response(s) to the 239C Letters will determine whether the case advocate follows mixed entity or scrambled SSN case procedures.

The procedures that the case advocate will follow in IRM 21.6.2.4.3, Mixed Entity Procedures, will depend on getting at least one taxpayer to respond, and on content of the response or responses provided by taxpayer or taxpayers.

No responses to any of the 239C Letters or the type of responses received in the 239C Letters requires the case advocate to follow procedures found in IRM 21.6.2.4.4, Scrambled SSN Case Procedures.

5. **Indication that two or more returns are filed by more than one person and the true owner of the SSN *cannot* be identified (a scrambled SSN issue)**

As a case advocate works a Mixed Entity case (discussed above), it may develop into a Scrambled SSN case based on its facts and circumstances. Per IRM 21.6.2.4.2, Multiple Individuals Using the Same TIN, a "true" Scrambled SSN occurs when the SSA assigns the same SSN to more than one taxpayer. These cases are rare and are not considered identity theft. IRM 21.6.2.4.2 also states that a "secondary" scrambled SSN occurs when one or both of the taxpayers are not the primary taxpayer and the true owner of the SSN cannot be identified.

The Scrambled SSN procedures, found in IRM 21.6.2.4.4, Scrambled SSN Case Procedures, are more complex than Mixed Entity procedures. They ultimately lead to a point where the SSA is contacted for information and investigation via SSA Form 3857, Request for SSN Clarification. The SSA's investigation can take up to two years to complete. TAS cases are worked by TAS offices located at IRS campuses. The case advocate closes the case once conditions in IRM 13.1.7.10.3.22, Scrambled SSNs, are met. The IRS Scrambled SSN Coordinator monitors case for the response from SSA and takes appropriate action based on SSA's response.

Scrambled SSNs are problematic for all taxpayers involved because until SSA responds to the IRS inquiry, subsequent returns are prevented from posting to the Common SSN, and refunds are frozen.

Servicewide All TAS Criteria	FY 2005 Sep Cum	FY 2006 Aug Cum
410 Multiple/Mixed TIN	1,493	1,829
420 Scrambled SSN	1,063	1,010
425 Stolen Identity	922	2,277

Additional Information:

- Identity theft was deemed a "Most Serious Problem" in my 2005 ARC.
- The Identity Theft Program Office maintains an Identity Theft web page for IRS employees. It includes a link to the TAS website.
- TAS identified portfolio advisors, a program analyst, and an attorney advisor to provide technical support to other TAS offices in addressing identify theft matters.

Question 23 (b):
Describe the coordination between the IRS and TIGTA to determine the jurisdiction of stolen or fictitious identity cases that impact tax administration. Identify any impediments to such coordination, including IRC section 6103 disclosure issues.

Response 23 (b):
I do not have the information required to answer this question. Information on identity theft is maintained by the IRS Identity Theft Program Office.

Question 23 (c):
How many stolen or fictitious SSN cases have been reported to the IRS during the last five years? How does the IRS track this figure?

Response 23 (c):
I do not have the information required to answer this question. Information on identity theft is maintained by the IRS Identity Theft Program Office.

Question 23 (d):
How many stolen or fictitious SSN cases have been worked by the IRS during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.

Response 23 (d):
I do not have the information required to answer this question. Information on identity theft is maintained by the IRS Identity Theft Program Office.

Question 23 (e):
How many stolen or fictitious SSN cases have been reported to TIGTA during the last five years? How does TIGTA hack these cases?

Response 23 (e):
I do not have the information required to answer this question. Information on TIGTA referrals should be available from TIGTA and perhaps from the IRS Identity Theft Program Office.

Question 23 (f):
How many stolen or fictitious SSN cases have been worked by TIGTA during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.

Response 23 (f):
I do not have the information required to answer this question. Information on TIGTA workload should be available from TIGTA.

Question 23 (g):
In the event of a recurring problem, i.e., the same SSN is claimed by more than one taxpayer for more than one year, is the case worked every year or resolved for all future years?

Response 23 (g):
I do not have the information required to answer this question. Information on identify theft is maintained by the IRS Identity Theft Program Office.

Question 23 (h):
Provide the Full Time Equivalents (FTEs) spent on ID theft cases during the last five years by the IRS and TIGTA.

Response 23 (h):
I do not have the information required to answer this question. Information on staffing should be available from the IRS Identity Theft Program Office and from TIGTA.

Question 23 (i):
To what extent do staffing levels impact on the IRS's, and TIGTA's, ability to work identity theft cases?

Response 23 (i):
I do not have the information required to answer this question. Information on staffing should be available from the IRS Identity Theft Program Office and from TIGTA.

Question 24:
Provide an analysis of the benefits and burdens on payers, payees, and the IRS, in connection with increased information reporting and withholding requirements. Include your conclusions and recommendations concerning an appropriate balance of benefits and burdens and the impact on effective tax administration.

Response 24:
In my 2004 ARC, I presented a chart listing various possible tax gap reduction initiatives and the various benefits and burdens of each initiative.[79] The chart also categorizes each initiative as "Most Intrusive," "Somewhat Intrusive," and "Least Intrusive," based on the level of burden it would impose on taxpayers and record keepers.[80]

After considering the benefits and burdens of these various measures, I made several administrative and legislative tax gap reduction recommendations in my 2005 ARC.[81] I believe that the benefits of implementing these recommendations outweigh the burdens they would place on taxpayers. These recommendations are summarized in Exhibits A and B to my written testimony.

My office continues to study the components of the tax gap, think about various proposals that would narrow the gap, and analyze the benefits and burdens of each proposal. In conducting our analysis, we try and evaluate each proposal on a case-by-case basis, and determine whether the benefits of implementing any specific proposal would outweigh the burdens it would impose. Our continuing benefits and burdens analysis of various tax gap reduction proposals has caused us to perfect some of the proposals first presented in my 2005 ARC, and to make new proposals not contained in that report. To respond to your question, I have listed my various legislative proposals, along with the benefits and burdens of each proposal, in Exhibit A to these Questions for the Record.

Question 25:
To what extent would raising public awareness of the importance of complying with tax laws impact the tax gap? Describe ways that raising public awareness could be achieved.

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[79] National Taxpayer Advocate, 2004 Annual Report to Congress, 483-489.

[80] *Id.*

[81] National Taxpayer Advocate, 2005 Annual Report to Congress, 55-75; and 381-396.

Response 25:
Raising public awareness of the importance of complying with tax laws has the potential to impact the tax gap. Educating taxpayers about the effect of noncompliance may help some noncompliant taxpayers come into compliance. The IRS Oversight Board 2005 Taxpayer Attitude Survey reveals that the vast majority of taxpayers do not believe it ok to cheat on your income taxes and almost as many taxpayers list their personal integrity as exerting a great deal of influence over their decision to report and pay their taxes honestly.[82] A number of states have adopted outreach strategies to address insurance fraud, focusing on personal integrity and the effects of individuals who commit insurance fraud. A similar outreach strategy from the federal government can educate taxpayers of the importance of complying with the tax laws. Additionally, the IRS should look to conduct outreach and education through elementary and high schools. By incorporating information regarding tax compliance and the importance of meeting your tax obligations into the school curriculum, the IRS can educate a generation of compliant taxpayers, who might also be able to affect their parents and family members.

Question 26:
The IRS website provides phone numbers and addresses for local IRS offices. Taxpayers are advised they can call a phone number, leave a message, and the call will be returned by the IRS within 2 business days. The Committee recently tested the level of service to taxpayers calling the IRS. Calls to 25 of these sites yielded only 18 returned phone calls, a 28% failure rate. Of the 18 responses, only one IRS caller suggested visiting the IRS website for information. The most prevalent recommendation by the IRS responders was for the caller to visit the local IRS office for assistance. IRS leadership explains proposed reductions in taxpayer assistance center hours and services are justified because of increased web services.

Question 26 (a):
Explain why 28% of the phone calls would not be returned.

Response 26 (a):
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 26 (b):
Explain the apparent disconnect between IRS leadership and front-line employees regarding the use of the IRS website as an information resource for taxpayers.

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[82] IRS Oversight Board, *2005 Taxpayer Attitude Survey*, available at http://www.ustreas.gov/irsob/releases/2006/02212006.pdf#search=%22roeper%20study%20taxpayer%20attitudes%22 (last visited September 11, 2006).

Response 26 (b):
The IRS website serves as an important resource for those taxpayers in need of information but who do not need face-to-face interaction with the IRS. Although the IRS website contains information about many tax issues, it should not serve as the sole information resource for taxpayers. While many taxpayers may choose to use the IRS website to obtain a form or publication, they may still need assistance from the IRS in answering tax law questions. While electronic and self-assistance channels such as the IRS website may be growing in popularity, mere use or access to these services does not necessarily mean that taxpayers are computer literate and can conduct site searches for complex tax information, much less understand how to apply that information once they find it. The IRS must always remain cognizant that there is a segment of the population that cannot and will not use the IRS website. However, by providing more self-service opportunities for taxpayers, the IRS should be able to reserve its in-person interaction, including speaking to taxpayers who phone a local office, for those issues and taxpayers that need such engagement.

Question 27:
TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," found that while the IRS has increased its examination coverage rate of high-income taxpayers, the increased coverage largely is due to correspondence examinations. TIGTA reported assessments of $1.4 billion on taxpayers who failed to respond to the IRS during correspondence exams, however, 71% of these assessments remained uncollected after almost 2 years. Given these results, is it efficient to use IRS resources to conduct a correspondence exam that can be ignored by a taxpayer without apparent consequence?

Response 27:
It is perhaps easy to conclude that correspondence examinations are not the most efficient way of examining taxpayers who do not respond to correspondence. Without input from the taxpayer, the IRS does not have all of the information that it needs to assess the correct amount of tax or even to determine if the taxpayer was required to file a return. Thus, TIGTA's finding that the IRS has to abate many of these assessments when taxpayers finally do respond is not surprising.[83]

It may also be easy to conclude that making assessments that the IRS does not collect is inefficient. TIGTA's report suggests that the IRS does not collect its assessments on many of the taxpayers who do not respond to correspondence

[83] The TIGTA report concludes that the IRS does not collect correspondence examination assessments against many taxpayers who did not respond correspondence either because the IRS later abated the tax or did not collect it. *See* Treasury Inspector General Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May be Limited*, 8 (July 25, 2006).

examination letters for two reasons.[84] First, the IRS normally takes a taxpayer's collection potential into account when determining whether or not pursue an assessment, but does not take collection potential into account in determining whether to pursue an assessment against a taxpayer who does not respond. As a result, a disproportionate number of assessments against non-responders may be uncollectible. Second, TIGTA notes that 60 percent of these accounts were in the collection "queue" waiting to be assigned because the IRS Collection function was working higher priority cases and did not have the resources to actively collect the assessments except through tax refund offsets. The report also suggests that the IRS's failure to collect against non-responders may have an indirect effect that reduces other taxpayers' willingness to comply with the tax law.

The IRS's failure to collect against non-responders probably does have a negative indirect effect on compliance. This failure may send the message that "even in the unlikely event that the IRS audits you, you can just ignore them because they do not have the resources to make you pay."

However, the existence of an indirect effect does not necessarily mean that the IRS should spend additional resources to collect such assessments. In the absence of additional appropriations, allocating more resources to lower priority accounts means that the IRS foregoes collecting on higher priority accounts, which sends a similar message and probably has a similar indirect effect. Rather, the IRS should develop more effective ways to examine taxpayers who do not respond to written correspondence so that it does not make so many assessments that it ultimately needs to abate.

Question 28:
TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," indicates that IRS management officials say they are working on a plan to better identify high-income tax returns for examination, *including placing less emphasis on non-filers.* TIGTA report #2004-30-127, "The Return Delinquency Notice Program Could Be Used More Effectively to Promote Filing Compliance and Reduce the Tax Gap," found that the number of potential individual non-filer cases increased from 6.1 million in 1994 to 8.9 million in 2001, but that IRS resources assigned to these cases had declined. TIGTA observed that the ability of the Return Delinquency Notice Program to effectively promote filing compliance has been significantly affected. TIGTA estimated at least $1 billion in taxes was foregone as a result.

Question 28(a):
Explain the IRS's decision to place less emphasis on high-income non-filers in light of these TIGTA reports.

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[84] *See* Treasury Inspector General Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May be Limited*, 9 (July 25, 2006).

Response 28(a):
Although the IRS sometimes changes its plans without informing TAS, we believe that the IRS does not plan to place less emphasis on high-income non-filers.

Question 28(b):
What impact would deemphasizing high-income non-filers have on tax administration and the tax gap?

Response 28(b):
If, in fact, the IRS is deemphasizing high-income non-filers, that would send the wrong message. The IRS has not done enough research to know what effect such de-emphasis would have on the tax gap.

Question 28(c):
Why do so many high-income taxpayers ignore correspondence audits? Is this true for other taxpayer groups, as well?

Response 28(c):
The IRS has had little success in determining why some taxpayers do not respond. As a result, we know very little about why high or low income taxpayers respond to IRS notices or correspondence examinations.

Question 28(d):
What can the IRS do to increase taxpayer response to correspondence audits?

Response 28(d):
In order to increase taxpayer response to correspondence audits, the IRS should develop a targeted strategy aimed at increasing the taxpayer response rate. This includes revising the correspondence sent to taxpayers to make it easier to understand. While the IRS has made improvements in the clarity of notices, the use of boilerplate language in notices makes it difficult for a taxpayer to understand what the IRS is asking. The IRS should also reevaluate its process for obtaining updated taxpayer mailing addresses when correspondence is returned to the IRS as undeliverable. Finally, the IRS should initiate contact with taxpayers who do not respond to a correspondence audit. Telephoning a taxpayer is a much more effective way of receiving a response than simply mailing a letter. The IRS should encourage its employees to call taxpayers who do not respond to correspondence audits in an effort to increase the taxpayer response rate.

Question 28 (e):
How can the IRS collect tax deficiencies resulting from correspondence audits sooner?

Response 28 (e):
The following measures would aid in earlier collection of tax deficiencies resulting from correspondence audits:

- Careful selection of the issues to be examined by correspondence examination rather than office audits
- Improved notice clarity
- Use of the Automated Collection System to place calls regarding the deficiencies
- Continuous issuance of notices rather than cessation of notices followed by resumption years later
- Additional research on undeliverable and unclaimed mail to make sure notices are being sent to the "most current" and "last known" address

Question 29:
TIGTA report #2006-40-067, "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program," found that at least 47 Taxpayer Assistance Centers are understaffed. What plans does the IRS have to ensure that TACs are staffed commensurately with taxpayer needs?

Response 29:
At the direction of Congress, the IRS, the IRS Oversight Board, and the National Taxpayer Advocate developed the Taxpayer Assistance Blueprint (TAB), a five-year plan for taxpayer service. Section 7.0 of the TAB Phase 2 Report, presented to Congress in April 2007, discusses the numerous research projects conducted by the TAB team to identify the needs and preferences of taxpayers and the IRS's plans with regard to TACs.

Question 30:
The May 27, 2006 IRS Filing Season Data reports 3,449,641 field assistance walk-in contacts, an 11.1% decrease from 2005. Describe how this count is taken. Are taxpayers who desire services not offered by the TAC included? Are taxpayers who appear outside the hours of service or when the TAC is closed for lunch counted?

Response 30:
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Responses to Questions from Senator Kerry:

Question 1:
What concrete steps should be taken to improve voluntary compliance?

Response 1:
The IRS should have a unified strategy prioritizing resources across gap components and Operating Divisions. Since the IRS currently lacks sufficient information to determine the most effective use of its resources, the plan the Service submits should emphasize and detail the steps that will be taken to address our information gaps. Such steps would include:

- Additional research needs to be done to update our information on compliance for all the tax gap components.
- We need to get a better understanding of the causes of noncompliance, because the most effective way to address a given compliance problem depends on why the taxpayer was noncompliant.
- Where we determine that the noncompliance was inadvertent, we should attempt to identify the cause for the taxpayer's error. This information could be captured as a part of the on-going National Research Program (NRP) process.
- Where the noncompliance is deliberate, additional studies are needed to determine the best way to proceed. Enforcement action may be required, but in many cases increased information reporting might be a better solution. Studies should:
    a. Investigate new approaches to information reporting, and weigh the cost of enforcement against the burden that information reporting imposes on taxpayers;
    b. Investigate the indirect effects of audits by industry and type of audit (e.g., correspondence audit, office audit, field audit) to enable us to determine which audits will be most cost effective, where we determine that examinations are necessary.

Question 2:
Is the underreporting of income the biggest contributor to the tax gap and if so, are there ways to significantly improve reporting that are not burdensome and costly for small businesses?

Response 2: Underreporting of business income accounts for about 43 percent of the gross tax gap, making underreporting the single largest component of the tax gap.[85]

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[85] Taxpayers who underreport business income on individual returns account for $109 billion of the gross tax gap and those who underreport self-employment income account for another $39 billion. IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts).

For the past four years, my office has been considering the benefits and burdens of various tax gap reduction initiatives. Based on our analysis, I have recommended three proposals for increasing information reporting, none of which would increase burdens on small businesses in any significant way:

- Amend Internal Revenue Code (IRC) § 6041A to require third-party information reporting for applicable payments to taxpayers doing business as corporations;[86]
- Amend IRC § 6045 to require information reporting on gross proceeds from sales conducted on Internet auction sites; and
- Amend IRC § 6045(a) to authorize the Secretary of the Treasury to prescribe regulations that require brokers to report adjusted gross basis information in conjunction with the sale of mutual funds and stocks.[87]

The first two proposals are discussed in my response to Question 8 below.

Question 3:
In a new report, the Treasury Inspector General for Tax Administration has criticized lapses in IRS security measures to protect against unauthorized access to returns. What is being done to address this?

Response 3:
The report cited, *Increased Managerial Attention Is Needed to Ensure Taxpayer Accounts Are Monitored to Detect Unauthorized Employee Accesses* (hereafter Report), was issued July 24, 2006 as reference number 2006-20-111. In the report, a number of systemic weaknesses were identified in the IORS (IDRS Online Reports Services) system, which "...hinder business unit managers from adequately reviewing and timely identifying potential unauthorized accesses to employees' and their spouses' accounts and noncompliance with security controls on the IDRS."[88] "For example, certain IORS system users were unable to retrieve IDRS Security Reports, and slow response times hindered business unit manager's reviews of IDRS Security Reports."[89] These systemic weaknesses are endemic to the existing IORS system, and the Treasury Inspector General for Tax Administration (TIGTA) recommends that system enhancements deserve priority.[90]

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[86] *See* National Taxpayer Advocate, 2005 Annual Report to Congress 394-396.

[87] *See* National Taxpayer Advocate, 2005 Annual Report to Congress 433-441.

[88] *Increased Managerial Attention Is Needed to Ensure Taxpayer Accounts Are Monitored to Detect Unauthorized Employee Accesses*, TIGTA Report dated July 24, 2006, Reference Number: 2006-20-111 3.

[89] *Id.* 3.

[90] *Id.*,4.

Appendix IV of the Report supplies Management's Response to the Draft Report. The IRS concurs with TIGTA Recommendations #1, #3, and #4, and does not concur with #2. Recommendation #2 suggests that the "...requirement to certify the monthly Security Profile Report to reduce managerial burden because the data is captured in the Quarterly Security Profile Reports." The IRS rebuts this, stating that the time lag during a quarter will act to prevent timely removal of employees from the system, and create delays to take corrective actions.[91] Taxpayer Advocate Service (TAS) concurs with *Management's Response to the Draft Report.*

TAS is a user of the IORS system. As such, it, like every other user, is subject to the limitations of the current IORS system. The Report also cited the Campuses as providing a wide range of emphasis and training to the users, which must necessarily include TAS. TAS presently includes the requisite report reviews as part of the Annual Assurance process and answers nine questions on the TAS Management Control Checklist.[92]

TAS will raise the priority of IORS reports and ensure that necessary training is available, where not already done. TAS will require managers to complete the various IORS reports in a timely manner. Finally, TAS will emphasize this during each Operations Review, performed annually on each Area and office to ensure that timely execution of all requisite IORS reports are completed by each TAS office that utilizes IDRS.

Question 4:
What percent and amount of the tax gap can be contributed to the earned income tax credit (EITC)? What percent of audits is conducted on EITC filers?

Response 4:
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 5:
In a new report, the Treasury Inspector General for Tax Administration indicates that 70 percent of the assessments on high-income taxpayers have not been collected. Why has this happened and what can be done to improve collection rates?

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[91] *Id.* 16-20.

[92] *TAS Management Control Checklist*, (rev. 4/23/2004), identifies nine questions under the heading of IDRS Security and Controls, on pages 7 and 8. Question 4 specifically addresses the IDRS Security Reports as cited in LEM 25.10.3.8.9.

Response 5:
It is perhaps easy to conclude that correspondence examinations are not the most efficient way of examining taxpayers who do not respond to correspondence. Without input from the taxpayer, the IRS does not have all of the information that it needs to assess the correct amount of tax or even to determine if the taxpayer was required to file a return. Thus, TIGTA's finding that the IRS has to abate many of these assessments when taxpayers finally do respond is not surprising.[93]

It may also be easy to conclude that making assessments that the IRS does not collect is inefficient. TIGTA's report suggests that the IRS does not collect its assessments on many of the taxpayers who do not respond to correspondence examination letters for two reasons.[94] First, the IRS normally takes a taxpayer's collection potential into account when determining whether or not pursue an assessment, but does not take collection potential into account in determining whether to pursue an assessment against a taxpayer who does not respond. As a result, a disproportionate number of assessments against non-responders may be uncollectible. Second, TIGTA notes that 60 percent of these accounts were in the collection "queue" waiting to be assigned because the IRS Collection function was working higher priority cases and did not have the resources to actively collect the assessments except through tax refund offsets. The report also suggests that the IRS's failure to collect against non-responders may have an indirect effect that reduces other taxpayers' willingness to comply with the tax law.

The IRS's failure to collect against non-responders probably does have a negative indirect effect on compliance. This failure may send the message that "even in the unlikely event that the IRS audits you, you can just ignore them because they do not have the resources to make you pay."

However, the existence of an indirect effect does not necessarily mean that the IRS should spend additional resources to collect such assessments. In the absence of additional appropriations, allocating more resources to lower priority accounts means that the IRS foregoes collecting on higher priority accounts, which sends a similar message and probably has a similar indirect effect. Rather, the IRS should develop more effective ways to examine taxpayers who do not respond to written correspondence so that it does not make so many assessments that it ultimately needs to abate.

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[93] The TIGTA report concludes that the IRS does not collect correspondence examination assessments against many taxpayers who did not respond correspondence either because the IRS later abated the tax or did not collect it. *See* Treasury Inspector General Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May be Limited*, 8 (July 25, 2006).

[94] *See* Treasury Inspector General Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May be Limited*, 9 (July 25, 2006).

Question 6:
What percent of audits are conducted on high-income taxpayers?

Response 6:
The requested information is under the control of the IRS, not TAS. My office understands that this question was also submitted to the IRS and that the IRS has responded to it.

Question 7:
I am a cosponsor of S. 2414, legislation sponsored by Senator Bayh that would require mutual fund companies to track and report to taxpayers information related to capital gains taxes. Do you believe that this legislation will help close the tap gap in the area of capital gains?

Response 7:
I recommended in the my 2005 Annual Report to Congress that Congress consider requiring broker-dealers to track and report their customer's cost-basis in stocks and mutual funds when sales are made. Under existing rules, brokers are required to file a Form 1099-B (Proceeds from Broker and Barter Exchange Transactions) with the IRS whenever a customer sells a security. However, the reporting rules only require the broker to report the gross proceeds the customer receives upon the sale. The broker does not have to report the customer's cost basis in the security. That omission is significant because a taxpayer's gain or loss on the sale of a security is measured by the excess of gross proceeds over cost basis. Thus, it provides an opportunity for noncompliance.

The absence of a requirement that brokers track and report customers' cost basis in securities has two consequences. First, it often imposes significant compliance burdens on taxpayers who may not have kept track of their cost basis. To illustrate, a taxpayer who has held AT&T stock since the 1980s has received shares in more than a dozen companies over the years, and on each such occasion, the taxpayer's cost basis had to be split between his existing holding and the spun-off company. Similarly, most mutual fund customers elect to have dividend and capital gain distributions automatically reinvested, and the customer's aggregate basis in a mutual fund holding changes upon each such distribution. If taxpayers don't have complete records, they will be unable to determine or substantiate their basis in many instances. We recommended requiring brokers to track and report cost basis primarily because it would make life much easier for honest taxpayers.

But the second consequence of the absence of cost basis reporting is that it affords less honest taxpayers with significant opportunities to overstate their basis and therefore understate their tax liabilities. Reliable estimates of the amount of underreporting in this area are difficult to come by, but two professors

have sized the problem at about $25 billion a year.[95] IRS officials studying the NRP data believe the revenue loss is lower, but they agree that the level of underreporting reaches into the billions of dollars. We have spoken with representatives of the brokerage industry and believe on balance that the revenue benefits of requiring brokers to track and report cost basis exceed the burdens the requirement would impose.[96]

Question 8:
In addition to S. 2414, are there other areas in which Congress should require third-party reporting?

Response 8:
As stated in my written testimony, under current law, an individual taxpayer can escape information reporting by incorporating. This is true even if the taxpayer is performing the same services that would be subject to Form 1099-MISC (Miscellaneous Income) reporting if the taxpayer were conducting business as an unincorporated entity (e.g., a sole proprietorship). For Form 1099-MISC information reporting purposes, I believe there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer has incorporated and another has not. There are, of course, many valid reasons for choosing to conduct business as a corporation, but information-reporting avoidance should not be such a reason. Corporate taxpayers who intend to comply with the tax law should have no objections to receiving a 1099-MISC for compensation for services performed or to IRS awareness of this compensation. Thus, I recommend that corporate taxpayers (including Subchapter S corporations) be subject to 1099-MISC reporting requirements to the same extent that unincorporated businesses are today.[97]
I also recommend that Congress consider requiring information reporting on gross proceeds from sales conducted on Internet auction sites. As with current rules governing Form 1099 reporting, such reports could be subject to a *de minimis* annual exemption (say, $600). One recent study found that 700,000 Americans reported that eBay sales constitute their primary or secondary source

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[95] Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question,* 106 Tax Notes 453 (Jan. 24, 2005).

[96] Congress could consider providing brokers with a one-time credit to offset the cost of implementing a comprehensive basis-tracking system.

[97] I initially recommended that only payments to corporations with 50 or fewer shareholders be subject to income reporting. In subsequent conversations with payroll and reporting professionals, I have been advised that it is often difficult for payors to know the payee's number of shareholders at any one time. These professionals recommend a unitary rule as easier to administer. I believe that the precise scope of a corporate reporting requirement should be determined after appropriate research and discussions with affected stakeholders.

of income.[98] The IRS must have the tools needed to address under-reporting of this income.

Question 9:
How can we simplify the EITC to improve compliance?

Response 9:
The adoption of a Uniform Definition of Child in 2004 was the first step in simplifying the EITC. Despite this significant step towards simplification, taxpayers claiming the different family status provisions, including the EITC, Child Tax Credit, Dependency Exemption, Head of Household Filing Status and the Child and Dependent Care Credit must still navigate a labyrinth of complex rules and requirements for each provision. Taxpayers claiming the EITC are also claiming many of the other family status provisions, the rules for which are often counter-intuitive and therefore lead to many inadvertent errors, while providing opportunities for deliberate fraud in some instances. By combining several provisions into one Family Credit, Congress can eliminate complex and often contradictory eligibility requirements still existent in the Code today. The creation of a Family Credit would build upon the simplification achieved with the Uniform Definition of Child and further simplify the family status provisions.

Other potential areas for improvement in the EITC Program may come from the current EITC Audit Barriers study. TAS is collaborating with the EITC Program Office and W&I Research on a study to identify the most significant barriers that taxpayers encounter during the EITC correspondence audit process. The results of the study will hopefully indicate areas of improvement for the EITC correspondence audit process.

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[98] John Cassidy, *Going Long,* The New Yorker, July 10 & 17, 2006, at 99 (citing an AC Nielsen study).

WRITTEN TESTIMONY OF

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

JULY 26, 2006

Introduction

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

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

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

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

Background

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

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

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

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

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

Consequences of the Tax Gap

Mr. Chairman, although these statistics can be mind-numbing, they represent real numbers that represent a serious problem in our tax administration system. The tax gap can have corrosive effects upon our entire tax administration system and the fiscal health of the nation. The tax gap's consequences are all too real and we feel them in our everyday lives.

- First, at the most basic level, the tax gap is an injustice. It means that honest taxpayers are bearing the financial burden of those who do not pay what they owe. The taxpayers who play by the rules – regardless of income bracket – pay more in taxes to make up for those who game the system and cheat. In a very tangible way, honest taxpayers are subsidizing those who evade their taxes.
- Second, it deprives our government of revenue to which it is entitled.
- Third, and perhaps most troubling, the tax gap undermines confidence in the fairness of our tax administration system and contributes to non-compliance.

Recommendations to Reduce the Tax Gap

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In testimony before the Senate Budget Committee, the National Taxpayer Advocate further recommended that to address the tax gap "we should begin by identifying various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose."[2] The Board supports such analysis. GAO has also made recommendations for legislative action that provide the IRS with better enforcement tools.[3]

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

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

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

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

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

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

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

The National Taxpayer Advocate has also suggested that the IRS could make it easier for taxpayers to pay their tax bills. She has suggested that the IRS should make it just as easy for taxpayers to make their estimated tax payments as it is to pay other bills. Many private sector creditors send customers bills to remind them when a payment is due, and many creditors offer the option of paying via automatic monthly withdrawals from the customer's bank account free of charge. Services such as these are likely to increase taxpayer compliance to the extent they can help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make tax payments.

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

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

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

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

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

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

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

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

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

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

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

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

Summary

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

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

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[5] Everson, *op.cit.*

Responses to Questions for the Record
Raymond T. Wagner, Jr.
Chair, IRS Oversight Board
September 8, 2006

From Senators Grassley and Kyl

Question 1

Tax Simplification: In your testimony, you make six recommendations for addressing the tax gap, and the first is for Congress to simplify the tax code.

- Do you think simplification or enforcement hold greater promise for improving taxpayer compliance?
- Can you give us some examples of areas of the tax code where simplification might most improve compliance?
- Which provisions of the tax code do you think confuse honest taxpayers? Which components encourage intentional under-reporting? And which result in the most difficulty for the IRS in evaluating compliance?

Response

Comparing the benefits of simplification with the benefits of greater enforcement of the current code is difficult because each option offers a range of implementation choices and positive effects associated with those choices. In general, a broad simplification offers greater promise and benefits to taxpayers over additional enforcement of the current code in the long run. However, the benefits of simplification depend on the extent to which simplification can actually be achieved. A vastly simpler tax code will decrease taxpayer burden and cost, even though there will be transition costs to implement a new code. A simplified code can also reduce the cost of enforcement.

Increased enforcement of the current code will be effective in improving the compliance of taxpayers on whom the additional enforcement is focused. There may also be some indirect compliance effects on taxpayers untouched by the IRS, but who are similarly situated and who learn without enforcement actions. Still, increased enforcement is usually limited in scope. Of course, simplification can also be focused, such as the recent re-definition of a qualifying child. A balanced approach, such as the Board has recommended, would be to do elements of both.

Because the Board is prohibited from becoming involved in tax policy, I would recommend that you look at the areas where the President's Advisory Panel on Tax Reform recommended changes. For individuals, the panel made recommendations related to eliminating the Alternative Minimum Tax (AMT), reducing the number of tax brackets, simplifying the number of exemptions, simplifying savings plans, simplifying the Earned Income Tax Credit (EITC), and eliminating the deductibility of state and local taxes. For businesses, they recommended simplifying depreciation, streamlining interest expense treatment, and eliminating the corporate

AMT. These recommendations would be a good place for the Finance Committee to begin its evaluation of possible changes.

As far as areas of confusion are concerned, again I would recommend that the committee look to the recommendations made by the tax reform panel. AMT and EITC are probably the most confusing of all. Education credits, savings incentives such as IRAs and 401(k)s, and capital gains rules can also be very confusing.

Question 2

Additional IRS Funding: I understand that the Oversight Board does not make legislative or policy recommendations, but the Board is charged with reviewing the IRS's budget. In your testimony, you recommend additional "investments" in taxpayer service ($43.6 million), enforcement ($367.8 million), infrastructure and management ($104.7 million), and business systems modernization ($188.6 million). In which of these four areas would funding increases be most cost-effective, in terms of improving compliance?

Response

That's a difficult question because each type of investment has a different effect. I would give the highest priority to modernization and infrastructure investments, because they offer the best potential for systemic improvement over the long run.

Question 3

Cash Economy: Your testimony also reports that the IRS Small Business/Self-Employed Operating Division will establish a task force on the "cash economy." What does the Oversight Board believe the goals of the task force should be? How could the IRS begin to address the cash economy in the context of both increasing information about the extent of the tax gap that relates to the cash economy and to increasing compliance?

Response

This task force is a joint effort between the SB/SE Division and the National Taxpayer Advocate. I believe the goals of the task force should be to identify new ways of systemically reducing the tax gap associated with the cash economy.

Learning more about the cash economy is an important part of developing strategies to more effectively achieve compliance among taxpayers that are part of this economy. For that reason, the task force should focus on identifying additional research that needs to be conducted. From there, it can begin to develop recommendations for changes in procedures and legislative changes, such as additional information reporting, that would increase compliance while minimizing additional burdens on taxpayers.

The Board recommends that the committee make the same inquiry of the IRS' Small Business and Self-Employed Division and the National Taxpayer Advocate to gain a wider perspective on this question.

Question 4

Business Income Underreporting: Mr. Wagner, we've heard from all our panelists this afternoon that addressing the tax gap will involve increased enforcement, more information reporting, and tax code simplification. According to the IRS's estimates, the largest chunk of the tax gap -- $109 billion -- is from underreported net business income by individuals. Can you please explain the roles that enforcement, information reporting, and tax code simplification might play in reducing this component of the tax gap? Are there any other measures that might address this component?

Response

The importance of information reporting cannot be overstated. Several witnesses testified at the hearing that where there is information reporting, there is compliance. For example, in the late 1980s, when the Tax Reform Act of 1986 required Social Security Numbers (SSNs) be identified for all dependents, it was estimated that the country lost almost 5 million fictitious dependents in a single year.

More enforcement does have a positive return on investment in that it will raise more in tax revenue than it costs. Estimates by the IRS for various types of enforcement activity range from four-to-one to six-to-one. Additional enforcement resources would enable the IRS to target industries where cash is key, such as construction or some service industries.

To take a wider view, however, it's important to view tax administration as a process. Enforcement occurs at the end of the process. Solutions that produce more compliant taxpayers at the beginning of the process can frequently be more effective than back-end processes. Simplifying the tax code is another front end solution, as simplification makes it easier for taxpayers to understand their obligations and provides fewer opportunities to manipulate the system. Helping taxpayers understand their obligations through education and outreach, as Nina Olson testified, is also very important. She makes a compelling case that inadvertent errors cause a lot of non-compliance, which can be potentially reduced by both simplification and education.

In addition, over 60 percent of taxpayers use paid preparers, and this number is higher for small businesses and the self-employed. We need to make paid preparers part of the solution as well. We should expect preparers to maintain the highest standards of competency and ethical behavior, and to help their clients in being compliant.

We must also work to influence public attitudes about tax compliance, with the expectation that compliance is the norm. Surveys by the Board indicate that personal integrity influences taxpayers far more than audits and third party reporting.

Question 5

Understanding the tax gap – resource challenges: Mr. Wagner, the IRS points to resource challenges as impeding the type of compliance studies that are needed to better understand the size and nature of the tax gap. What observations do you have on these resource challenges?

Response

The importance of research cannot be over-emphasized. We need to know more about non-compliance to effectively deter it, especially where and why it occurs. Knowledge is power, and will allow us to spend our resources more effectively.

I understand that it is difficult to increase the amount appropriated to federal agencies, but failure to fund additional research could easily be characterized as penny-wise and pound-foolish. Compliance studies will help the IRS decide how to most effectively allocate its current resources, explore the relationship between taxpayer service and compliance, develop strategies based on an understanding of where non-compliance is occurring and why, and measure progress in combating it. The ability of the IRS to rapidly engage in efforts to reduce the tax gap requires current data about compliance and non-compliance that effectively drive decision-making and enforcement efforts.

Question 6

Personal Integrity: In your testimony you state that emphasizing personal integrity must be one avenue of addressing the tax gap. How would "personal integrity" be emphasized as a program to increase voluntary compliance?

Response

The Board has taxpayer survey data that support the importance of emphasizing personal integrity. The Board has been collecting data on the factors that influence compliance by conducting surveys of public opinions on tax issues since 2002. One question that the Board asks is how much influence does each of the following factors have on whether you report and pay your taxes honestly? The four factors are:

- Fear of an audit
- Belief that your neighbors are reporting and paying honestly
- 3rd parties reporting your income (e.g., wages, interest, dividends) to the IRS
- Your personal integrity

The response is to be given on a five point scale from very influential to not influential. The table below shows the responses to this question in 2002 through 2005.

How much influence does each of the following factors have on whether you report and pay your taxes honestly? Would you say it has a great deal of influence, somewhat of an influence, very little influence, or is not at all an influence?

	A great deal of influence				Somewhat of an influence/%				Very little influence/%				Not at all an influence/%				DK/NA/NR			
Factor/Year	05	04	03	02	05	04	03	02	05	04	03	02	05	04	03	02	05	04	03	02
Fear of an audit	36	35	37	29	26	25	22	25	16	16	14	13	19	20	23	30	3	5	4	4
Belief that your neighbors are reporting and paying honestly	21	20	18	20	21	22	20	18	19	20	18	15	33	32	40	40	6	6	4	7
3rd parties reporting your income (e.g., wages, interest, dividends) to the IRS	41	37	37	33	27	32	27	27	11	10	11	11	17	15	21	22	4	6	4	7
Your personal integrity	82	79	73	74	13	12	15	14	3	3	5	4	1	2	5	4	1	3	2	4

As can be seen from the table, since 2002, personal integrity has scored in the high 70s and low 80s as either very or somewhat of an influence, more than double that of any other factor. Although the survey measures what people say about integrity, not necessarily how they act on this belief, it is still an important finding.

In developing communication strategies with taxpayers, one element of those strategies should be to remind taxpayers of the importance of integrity in making tax decisions, and that applying integrity to tax decisions is a characteristic of a good citizen. It would be unrealistic to expect that such a message would produce overnight results, but a slow transformation of values over time would be a reasonable expectation, and one that could be measured. A long term reduction in the percentage of traffic fatalities involving alcohol has been experienced in this country, and I believe this reduction can be correlated with a sustained media campaign by various groups that changed public attitudes about drunk driving. Similar results could be possible relative to paying taxes honestly.

The IRS already makes it a point to publicize prosecutions of egregious tax cheaters and those selling illegal tax shelters with the goal of emphasizing that cheating does not pay. Emphasizing personal integrity applies this same logic with a positive spin: being honest is the right thing to do.

Question 7

Additional resources/enforcement: Mr. Wagner, the IRS Oversight Board recommended over $700 million of additional resources for the IRS in the areas of taxpayer service, enforcement, infrastructure and management, and business systems modernization. Can you please describe the increased level of enforcement these funds would provide and give us your best guess as to how much of the tax gap might be addressed? If we only considered increased enforcement, what would it take to significantly reduce the tax gap and what would that entail?

Response

The most effective way to reduce the tax gap is to improve taxpayer voluntary compliance. Effective enforcement can help to influence taxpayers to be compliant voluntarily, and effective

enforcement can have a deterrent effect on taxpayer behavior that causes them to become more compliant, but other factors are important also. The Board has made a number of recommendations for additional resources in its FY2007 budget recommendations that include a variety of activities.

The Board recommended an additional $44 million for telephone service. The IRS has made a lot of gains in telephone service, but the Board recommended a budget that would restore telephone service to 2004 levels. Ensuring honest taxpayers understand their tax obligations and get answers to their questions are fundamental building blocks for improved voluntary compliance. The Board also recommended an additional $300 million for technology, including BSM and infrastructure improvements. These funds would help the IRS become more efficient and deliver major improvements to taxpayers in the long term. One major improvement that the IRS needs to make is to update its records on a daily basis. For example, daily updates can identify and resolve tax deposit errors more quickly, reducing the time IRS and the taxpayer waste on moot transactions. Private sector banks update their accounts daily, but the IRS still updates their account status weekly. The IRS needs to finish its CADE project and replace the Individual Master File as quickly as possible to be able to update its records on a daily basis. Other projects such as Modernized e-File and Filing and Payment Compliance should also receive higher funding.

The Board recommends an additional $370 million for enforcement. The biggest piece of this increase was about $140 million more for enforcement associated with small business and self employed taxpayers, a significant source of the tax gap. It also recommended about $30 million each for more enforcement of abusive schemes and EITC payments. Another major component was $60 million for additional research. We need to know more about non-compliance to combat it effectively.

With respect to the second part of the question on increased enforcement, the Board believes that enforcement alone is not enough. Balance is the key. The IRS estimates that increased enforcement activity can have measurable direct effects of approximately 4-6 to 1 on average. This return on investment means that increased enforcement pays for itself. However, investing a billion dollars to get back five billion doesn't close an annual tax gap of $300 billion by a significant degree. As mentioned earlier, enforcement can have indirect effects on taxpayer compliance in that it IRS enforcement presence influences taxpayers to be more compliant. However, the magnitude of these likely indirect effects have not been validated. Thus, enforcement by itself can only go so far in closing the tax gap. That is why tax code simplification and the other actions are so important.

Question 8

1993 Report: I think it is interesting that a 1993 report by the Treasury Department and the Office of Management and Budget determined that "enforcement is the most costly option and delivers only limited revenue." Do you agree? That same report found that "methods to increase voluntary compliance are less costly but more burdensome to taxpayers." Is this referring to increased reporting and/or withholding? Or to other options? Lastly, that report made several other recommendations that might still be instructive. Perhaps the most interesting revelation is

TIGTA's comment that they were unable to determine if the report's recommendations were implemented. Do you know if any of the recommendations were implemented?

Response

The Board, which was established in September 2000, is not familiar with the 1993 report. However, the Board's recommendations for closing the tax gap are not suggesting that one option must be chosen over another. In fact, the Board believes the opposite to be true. Increased enforcement has its benefits, as does better information reporting. It would not be effective to require more information reporting if there was no enforcement activity that leveraged the additional information that was reported. A multi-faceted approach is needed that requires action on many fronts, including simplification, better information reporting, effective service, additional research, and additional enforcement.

TIGTA is in a much better position than the Board to evaluate whether the report's recommendations were implemented. However, the Board is unaware of any concerted, systemic program to reduce the tax gap since the Board's inception. Any such effort would require a measurement program to evaluate progress and no such program was in place between the timer the Taxpayer Compliance Measurement Program (TCMP) was discontinued in the early 1990s and the National Research Program was established in 2001. It is possible to implement recommendations without having measures of success, but the ability to evaluate progress compared to objectives is usually considered a critical success factor.

Question 9

Under current law, the IRS is required to keep accounts receivable on the books for ten years -- and thus amounts that it knows are uncollectible cannot be written off for that period of time. Would it make sense to reduce that to a shorter length of time so that we have a truer picture of the accounts receivable inventory -- e.g., six years?

Response

It is generally accepted in the collection industry that older inventory is more difficulty to collect than more recent inventory, but the IRS has performed analyses in the past to develop estimates of how much is potentially collectible, and analyzing the inventory by age should be easily done. Decreasing the length of time the uncollectible remains on the books is not the only way to see a truer picture of the accounts receivable inventory. It is a common practice in the private sector to show receivables by age, and a shorter collection period is not needed to do so.

From Senator Hatch

Question 1

Why would we expect that the difficulties in complying with a tax code would necessarily increase the tax gap? If these are mistakes made by well-meaning individuals, wouldn't there also be many taxpayers who mistakenly pay *too much* tax as well?

Response

Admittedly there is limited information on the distribution of mistakes in favor of taxpayers or the government. Examples of mistakes that favor taxpayers include forgetting about cash income, dividends, or interest earned, improper use of a deduction, or failure to calculate whether alternative minimum tax is owed.

It is also possible for taxpayers to make mistakes that favor the government. One such example would be to itemize deductions when the standard deduction is actually higher. Although it may be easy for a taxpayer to forget about small amounts of unearned income, it would seem more unusual for a taxpayer to claim income he or she didn't earn. Where doubt exists, it would seem probable that taxpayers would give themselves the benefit of the doubt instead of giving it to the government.

The IRS National Research Program (NRP) has collected some data that distinguishes misreporting on individual tax returns that result in over-payment of taxes versus misreport that result in under-payment of taxes. A paper presented at the 2005 IRS Research Conference, *Recent Research on Tax Administration and Compliance*, showed that errors that underreported tax liability were about five times more likely than errors that overreported tax liability. If a small tolerance level of $100 was established to eliminate small mistakes, the ratio of underreporting to overreporting grew to almost eight to one.

Question 2

What effect has tax-preparation software such as TurboTax had on the tax gap? Do you believe that using such software encourages compliance in general or makes it easier for taxpayers to cheat?

Response

A recent Oversight Board survey found that among self-preparers, more than half (about 54 percent) used tax assistance software, and about 43 percent used paper and pencil. Self-preparers constitute about 40 percent of taxpayers, with the other 60 percent using paid preparers. The Board has found in discussions with paid preparers a very high use of tax software. Thus, it would seem that about 80 percent of returns are prepared using tax assistance software.

Although it is likely that tax software has numbed taxpayers to the true complexity of the tax code, it undoubtedly eases the burden that taxpayers face in performing burdensome

mathematical calculations, some of which require separate worksheets. Tax software automatically calculates whether AMT is owed, which relieves taxpayers of some very burdensome calculations. It also offers the advantage of automatically re-calculating the entire return if a mistake is made, a tedious and error-prone process when done using paper and pencil. Although tax software may offer some opportunities for taxpayers to cheat, the benefits seem to clearly outweigh the disadvantages.

In summary, for those taxpayers who want to honestly pay what they legally owe, software assists taxpayers to better understand their obligations and prevents them from making math errors. For those taxpayers who might be inclined to cheat, it is possible that software makes cheating easier to accomplish.

The Board is heartened by our 2005 taxpayer attitude survey results which show that 96 percent of taxpayers completely or mostly agree that it is every American's civic duty to pay their fair share of taxes. In the same survey, 88 percent of taxpayers responded that it is "not at all" acceptable to cheat. Thus, software appears to be doing far more good than harm.

Question 3

Mr. Wagner, what are the top three things Congress can and should do to reduce the tax gap?

Response

The Board has made a number of the recommendations that require Congressional action. The two that stand out are simplifying the tax code and authorizing additional information reporting. A third Congressional action would be funding the IRS at the levels recommended by the Board.

From Senator Baucus

Question 1

Identify and discuss the five primary causes of the tax gap.

Response

IRS research indicates that the biggest contributors to the tax gap are individual income tax from business income ($109 billion), non-business income ($56 billion), self-employment tax ($39 billion), non-filing of individual income tax ($25 billion), and under-payment of individual income tax ($23.4 billion). However, the causes of these elements of the tax gap are not known. These types of non-compliance may be caused by such factors as non-advertent errors, ignorance of the taxpayers' tax obligations, or deliberate non-compliance, but little definitive research exists on the exact causes of the tax gap. Additional research may identify more information on the nature of various tax gap elements, including a better sense of the factors that lead to non-

compliance. However, getting this type of information requires a more refined level of research than previously conducted.

Question 2

To what extent is the IRS directing its resources toward the five primary causes of the tax gap? What measures are used to determine whether the IRS's efforts constitute the optimal use of resources to improve voluntary compliance and close the tax gap?

Response

The IRS Strategic Plan 2005-2009, approved by the Oversight Board in 2004, establishes three broad goals for the IRS: 1) improve taxpayer service, 2) enhance enforcement of the tax law, and 3) modernize the IRS through its people, processes, and technology. The IRS has measures and performance targets that allow it, the Oversight Board, and other oversight bodies to monitor IRS performance against goals it has set, such as level of telephone service, accuracy of response, timeliness, number of audits conducted, and tax revenue collected. However, the IRS is only now beginning to establish long-term compliance goals, and the Board and the IRS are currently evaluating candidate long-term measures. Such measures may include long-term goals for taxpayer voluntary compliance. However, to measure progress in achieving long-term goals, effective measures must be established and the IRS needs to have the resources to conduct the necessary research on a continual basis, as recommended by the Board in its FY2007 budget report.

Without fully understanding the impact of both service and compliance on taxpayer voluntary compliance, the IRS must make management judgments on how best to allocate resources. The Board evaluates those judgments and makes independent recommendations to Congress on IRS resource requirements.

Question 3

Identify and discuss the five primary impediments to voluntary compliance.

Response

In an ideal world, voluntary compliance would be easy to achieve and difficult to avoid. Taxpayers would understand their tax obligations with minimum burden and be able to easily engage in transactions with the IRS to pay what they owed fully and timely. The incidence of inadvertent mistakes would be low and deliberate non-compliance would be unusual because taxpayers had high standards of personal integrity and the probability of detection for non-compliance was high.

The large size of the tax gap reminds us that we do not live in an ideal world, and our system of tax administration falls short of ideal conditions. Although the impediments to voluntary compliance have not been verified, the Board believes the following considerations all have an impact on taxpayer compliance.

- The overwhelming complexity of the tax code makes it difficult for taxpayers to understand their obligations and difficult for the IRS to easily assess taxpayer compliance. Moreover, complexity provides opportunities for those who are willing to exploit the system to evade taxes.
- The cash economy provides taxpayers with opportunities for undocumented income. Analysis of taxpayer compliance has shown where there is information reporting, voluntary compliance is high, and where information reporting is non-existent, compliance is low.
- Although IRS service levels have improved in the last five years, taxpayers can still experience difficulties in understanding their tax obligations. Oversight Board taxpayer attitude surveys indicate that almost two-thirds of taxpayers (66 percent) completely or mostly agree that the IRS should receive extra funding so it can assist more taxpayers over the phone and in person, a sign that taxpayers believe more service is needed. Eighty six percent of taxpayers completely or mostly agree that the more information and guidance the IRS provides, the more likely people are to correctly file their taxes.
- Insufficient enforcement allows taxpayers to escape accountability for being non-compliant. Based on Oversight Board survey results, nine out of ten taxpayers (93 percent) believe that everyone who cheats on their taxes should be held accountable, and almost two-thirds (63 percent) completely or mostly agree that the IRS should receive extra funding to enforce tax laws and ensure taxpayers pay what they owe, a sign that a large majority of taxpayers believe there should be more IRS enforcement of the tax laws. This support for additional funding seems to recognize that additional IRS enforcement presence will have a positive effect on compliance.
- Outdated IRS technology makes the conduct of tax transactions more difficult than it could be. Conducting transactions with the IRS and determining the status of tax accounts is still not as easy as dealing with a bank or credit card company.

Question 4

Identify and discuss the five primary burdens of taxpayers in meeting their tax obligations.

Response

The burdens on taxpayers can be enormous. In March 2005, Prof. Joel Slemrod from Michigan University, a noted expert on taxpayer burden, testified to the President's Advisory Panel on Federal Tax Reform that individual taxpayers experience $85 billion in burden every year in meeting their tax obligations, and that businesses (other than sole proprietorships) experience $40 billion annually in burden. These compliance costs considerably exceed the IRS budget for tax administration of almost $11 billion.

To cope with this burden, about 60 percent of taxpayers engage the services of paid tax preparers, one sign that most taxpayers believe they need help. Another approach to understanding taxpayer burden is to examine how and why taxpayers seek assistance from the IRS. The Oversight Board recently completed a special survey on taxpayer needs and service channel preferences. The table below shows the percentage of taxpayers in the survey that reached out for assistance from the IRS, the service channel they used, and the reason they contacted the IRS.

Taxpayer Service Needs and Channel Used

Reason for Assistance	Channel Used (percent of taxpayers using channel)				
	Call	**Website**	**Mail**	**TAC**	**E-mail**
Tax Law	15%	17%	0%	8%	8%
Help in Receiving Publications	14	38	5	29	12
Download/Get Publications	*	10	3	5	9
Prior year's return	6	2	3	4	7
Preparing return	7	6	3	16	17
Dispute/error	11	2	32	2	13
Respond to Notice	3	0	12	4	3
Making a payment	7	*	12	4	0

Source: Oversight Board Service Channel Survey (unpublished)

Question 5

Identify and discuss the five primary concerns of IRS external stakeholders.

Response

Each year the Oversight Board conducts a public meeting with external stakeholders and meeting in small group settings with IRS employees and tax practitioners at IRS nationwide tax forums and field meetings. The Board publishes the comments and recommendations received in its Annual Report to Congress. The following are stakeholder concerns noted in 2005. Details can be found in the report.

- There is a growing perception of widespread non-compliance that the IRS must address in an environment of limited resources and tax law complexity
- The IRS faces the challenge of maintaining customer service levels while changing the focus to enforcement
- Modernization of IRS information systems, while beneficial to the agency, can create difficulties for certain taxpayers
- There are ways the IRS can work more closely with stakeholders to increase levels of voluntary compliance
- Most tax professional organizations favor some form of registration and/or regulation for tax preparers and want a national discussion on the topic
- Recruitment, development, and retention of a qualified workforce is essential for the IRS in today's complex tax environment
- Stakeholders have concerns about how the IRS will implement the private agency collection of tax debt

- Despite consolidations, employees still report the lack of a sense of one IRS across operating and functional divisions

Question 6

Identify and discuss the five most significant impediments to the IRS's efficiency and effectiveness. What is the IRS doing to eliminate or mitigate these impediments?

Response

This question could likely be answered in more depth by the IRS itself. However, to provide some independent considerations from a governance perspective, the Oversight Board offers the following observations on IRS efficiency and effectiveness.

- The complexity of the tax code not only makes it difficult for taxpayers to understand and meet their tax obligations, it also makes it very difficult for the IRS to detect taxpayer non-compliance. A simpler tax code would make it much easier for IRS to administer taxes and perform both service and enforcement functions.
- Several organizations, including the IRS, GAO, TIGTA, and the NTA have noted that additional requirements for taxpayer information reporting would allow the IRS to more systemically identify sources of non-compliance, which in turn allow for a more efficient use of IRS resources.
- The work of the IRS is hampered by outmoded technology systems. The primary example of this problem is the IRS Master Files, which are based on 1960s technology and only support weekly updated of IRS central tax records. Private sector financial institutions have transitioned to daily updates years ago.
- Timely and accurate data on the impact of customer service on compliance and the sources of non-compliance would allow the IRS to improve its selection of cases for enforcement action and improve the effectiveness of customer service.
-

Question 7

Identify and discuss the five most significant resource challenges facing the IRS.

Response

The Oversight Board, in its FY2007 budget report to Congress, recommended over $700 million of additional resources for the IRS in the areas of taxpayer service, enforcement, infrastructure and management, and business systems modernization.

The Board recommended an additional $44 million for telephone service. The IRS has made a lot of gains in telephone service, but the Board recommended a budget that would restore telephone service to 2004 levels.

The Board also recommended an additional $300 million for technology, including BSM and infrastructure improvements. These funds would help the IRS become more efficient and deliver major improvements to taxpayers in the long term. One major improvement that the IRS needs to

make is to update its records on a daily basis. Private sector banks update their accounts daily, but the IRS still updates their account status weekly. The IRS needs to finish its CADE project and replace the Individual Master File as quickly as possible to be able to update its records on a daily basis. Other projects such as Modernized e-File and Filing and Payment Compliance should also receive higher funding.

The Board recommended an additional $370 million for enforcement. The biggest piece of this increase was about $140 million more for enforcement associated with small business and self employed taxpayers, a significant source of the tax gap. It also recommended about $30 million each for more enforcement of abusive schemes and EITC payments.

Another major component was $60 million for additional research. The IRS needs to know more about non-compliance to combat it effectively.

Question 8

Identify and discuss the five primary impediments to delivering top quality customer service.

Response

Top quality service results from meeting customer needs. The table presented in the answer to question 4 identifies service needs where taxpayers are currently seeking assistance from the IRS and the channels that taxpayers are using to obtain those services. In recent years the IRS is experience budget pressures on service as it tries to apply more resources for enforcement. It has kept telephone levels of service high in doing this, but did propose the closing of about half its Taxpayer Assistance Centers in FY2006 to reduce costs for in-person service, the most expensive service channel used by the IRS.

The biggest challenge to the IRS with respect to customer service will be to evolve its service offerings in recognition of budget constraints while maintaining or even increasing service to levels that taxpayers need and expect. The IRS has established a Taxpayer Assistance Blueprint project to develop a five year plan that guides the development of IRS service. A serious impediment in designing this evolution is the lack of data on the impact that service has on taxpayer compliance. Such data is essential if the IRS is to offer services that assist taxpayers reach a state of voluntary compliance and the costs and benefits of taxpayer service is to be understood and justified.

The IRS must also implement measures that reflect characteristics important to taxpayers, such as accuracy, timeliness, customer satisfaction, and wait times, so that it can assess its own performance and oversight organizations, such as the Board, GAO, TIGTA, and Congress can evaluate IRS performance in light of expectations.

Question 9

Identify and discuss the five primary technological impediments the IRS is experiencing.

Response

This question could likely be answered in more depth by the IRS itself. However, to provide some independent considerations from a governance perspective, the Oversight Board offers the following observations on technological impediments.

Perhaps the biggest technological impediment the IRS is experiencing is the use of antiquated technology for maintaining central tax records and an aging infrastructure that requires upgrading. Its antiquated computer systems in particular impose severe business limitations on the IRS.

In the past, the IRS has experienced cost and schedule delays on BSM projects, but in recent years the IRS has been able to deliver BSM projects on time and within cost. The recent failure of the IRS to field the Electronic Fraud Detection System (EFDS) for the current tax year indicates that it has some problems developing non-BSM projects. The discipline of risk management would have helped to prevent that failure as well. Implementation of good security has been a concern of GAO and TIGTA, and its presence on the TIGTA high risk list seems appropriate.

Question 10

Identify and discuss the five primary collection impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?

Response

The Board believes that the IRS is the best source of information on specific collection impediments it is experiencing, but it offers the following observations from a governance perspective.
The use of tax records that are updated weekly instead of daily prevents the IRS with a serious business process impediment to collection. Private sector collection companies maintain up to date records on cases they are pursuing. Such records would also allow the IRS to have more flexibility in tailoring collection actions for specific cases. Outsourcing its collection to private collection agencies should assist in alleviating these impediments.

A lack of collection resources to work cases is also a serious impediment. The Board has recommended additional collection resources for the IRS for the last five years; Congress has never appropriated resources to the levels recommended by the Board.

The Offer in Compromise program has been highly scrutinized by TIGTA and GAO, and both organizations have made recommendations on how to improve this program. The Board has also received comments and recommendations from its external stakeholders on ways to improve this program. The case backlog has been reduced over the past year, primarily driven by the lack of receipts. However, many cases are still classified as not processable or must be returned to taxpayers for more information. Recent legislative changes to require a 20 percent payment with the receipt of an offer have been criticized by external stakeholders, but it is too early to see what effect this new requirement will have. The number of cases processed for reasons of effective tax administration continue to remain low. A clarification of Congressional intent for this program would help evolve the program to better meet the original intent of Congress when it first authorized the closing of OIC cases for reasons of effective tax administration.

Question 11

Identify and discuss the five primary examination impediments the IRS is experiencing. To what extent is legislation necessary to remove any of these impediments?

Response

The Board believes that the IRS is the best source of information on specific examination impediments it is experiencing, but it offers the following observations from a governance perspective.

The IRS measures its output in conducting various types of examinations, from those of individuals in every income bracket to corporate returns, estate returns, and those of tax exempt organizations. The Board monitors on a quarterly basis not only output rates for various types of exams, but other balanced measures associated with examinations such as quality, timeliness, and customer satisfactions. These measures give the Board an understanding of productivity, quality, timeliness and other trends associated with the examination program, and the Board uses this information to evaluate whether the IRS is meeting its organizational goals.

However, the current measures cannot be used to evaluate how effectively the various examination programs of the IRS are affecting taxpayer compliance. There is currently insufficient information on the correlation between the examination rate, or other qualities associated with the examination program, and the desired outcome: improved taxpayer compliance. The IRS has a good understanding of the direct effects of enforcement, but the magnitude of the indirect (deterrent) effect of enforcement is not well understood.

The Board, and other oversight organizations, can evaluate how well the IRS is meeting its target performance goals, but, without a goal for improving compliance, the examination program, is operating without a feedback mechanism to assess the impact of compliance. A recent TIGTA report, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited,* report # 2005-30-015, comments on this same issue.

The report states that the IRS can reach more taxpayers at a lower cost through correspondence examinations than through more labor-intensive, face-to-face examinations, thereby increasing the coverage rate. It notes that correspondence examinations are important to ensure compliance, but focus on errors and examination issues that typically can be corrected by mail. Thus, they are less complex than face-to-face examinations. The report states that it is difficult to determine through correspondence examination techniques whether these taxpayers have reported all of their income, and that the Examination program for high-income taxpayers may not be positively affecting compliance given the substantial assessments that have been abated or not collected.

Although the report sheds some light on IRS' examination program, without knowing the impact the examination program has on taxpayer compliance, the effectiveness of the examination program cannot effectively be assessed. The Board has recommended additional funding for IRS research so it can be made an on-going program. Such a change would improve the ability of the IRS, as well as oversight groups, to assess the impact enforcement has on compliance.

Question 12

To what extent will the high percentage of retirement-eligible employees at the IRS impact the tax gap within the next five years? 10 years?

Response

The number of retirement-eligible employees at the IRS is growing and attrition numbers in the various divisions do indicate that the number of retirements is increasing. The impact this has on the tax gap in the next five to ten years is difficult to assess, but clearly the IRS is faced with the problem of replacing highly-experienced, highly-skilled employees with new employees.

This problem is of concern to the Board and has been cited in the Board's Annual Reports for the last several years. This problem can be mitigated by developing new modern processes and technology to perform service and enforcement functions so there is less dependence on older methods, and second, but placing more emphasis on training of new employees. The Board has recommended additional budget for BSM and training in the last several years to accomplish these objectives. However, BSM and training budgets have in fact decreased in recent years.

On a positive note, the Board approved the IRS Human Capital Strategic Plan in March of 2006. By developing a Human Capital Strategic Plan and the accompanying Human Capital Implementation Plan, the Service is taking a long-range, strategic look at its personnel needs and beginning to address the challenges it is facing. In taking these actions, the Service hopes to mitigate the impact of upcoming retirements on its missions of service and enforcement.

The IRS reported in its Human Capital Strategic Plan that as of April 2005, nearly 30 percent of its total 105,000+ employees would be retirement-eligible during FY2004 through FY2008. Nearly one-half of IRS employees, or over 48,000, are deemed "mission critical." These critical employees are customer service reps, tax specialists, tax examiners, revenue agents, revenue officers, appeals officers and special agents. These occupations are critical to front-line enforcement and direct support to front-line operations needed to meet IRS goals. Most mission critical employees are in the W&I and SBSE operating divisions and play key roles in IRS' enforcement efforts.

To address this challenge, the IRS Human Capital Strategic Plan identifies its top two goals as 1) Continually assess and shape the workforce to efficiently accomplish the Service's mission; and 2) Increase employee proficiency and engagement to enhance tax law compliance. IRS has established a cadre of full-time, trained recruiters and redesigned its recruiting function to meet corporate servicewide recruiting needs. Several leadership succession-planning efforts are underway throughout the Service the circumvent the potential effects of managerial retirement eligibility; but budget limitations have impacted the further development of non-supervisory succession-planning and leadership training development plans. The Service is also exploring additional options for monitoring attrition and migration of mission critical employees with the Service to better define recruitment needs.

Question 13

What is the IRS doing to retain experienced employees eligible for retirement?

Response

Many federal agencies are experiencing the situation of having a large number of experienced employees who have become retirement eligible. The IRS is not unique in this regard. One major

concern is that these experienced people will be lost to the agency before they have an opportunity to pass along their knowledge to the next generation of workers. Compounding the problem is the fact that tight budget and reductions in staffing levels have prevented the IRS from being able to hire large numbers of new employees who are available to be trained by the outgoing retirees.

There is broad interest by many agencies in legislative changes that will allow them to make it more attractive for key employees to stay on the job, including the payment of bonuses and the ability to work on a part-time basis without impacting their retirement benefits.

As noted in the answer to the previous question, the Board has approved the Human Capital Strategic Plan, which established within its Implementation Plan the following key projects for addressing this issue. The IRS is refining a strategic workforce plan that identifies workforce trends, gaps and human capital needs across the service. The desired outcome for this plan is to get the right people with the right skills in the right place at the right time, to the benefit the agency's mission. To accompany this, the IRS is also developing a workforce analysis suite, a collection of technology driven analysis workforce data elements, including migration analysis, attrition, and retirement projections designed to inform management and offer input to business decisions.

By increasing the availability of worklife flexibilities, such as telework, flexible schedules and flexiplace, the IRS is able to retain its senior employee expertise so that knowledge and experience can be transferred to younger personnel. The IRS is also placing more emphasis on mentoring programs and reward flexibilities that provide formal and informal recognition of superior employee performance. In addition to these efforts, the IRS is developing a service-wide retention strategy, to retain competent employees once the recruitment and training investments have been made.

Question 14

Describe the IRS's plans to transfer knowledge, skills and abilities from experienced workers to new workers, and to hire workers to replace employees who retire.

Response

As noted in the answer to the previous question, the Board has approved the Human Capital Strategic Plan, which established the following strategy for dealing with this issue.

The IRS is identifying and preparing for the competency needs of the future by doing occupational analysis. Analysis of the needs of each occupational series identifies increased proficiencies that are needed to handle new workloads associated with a changing compliance environment. This analysis identifies competency gaps and training that is necessary to close the gaps. The knowledge, skills and abilities of the retirement eligible workers may not be the same knowledge, skills and abilities that the IRS needs for its workforce of the future. For example, while a senior worker may have certain specific tax law or interpersonal skills, a newly hired younger employee may have better technical and computer skills. To address this, the IRS is utilizing experienced employees as trainers for the newly-hired, and continuing to use classroom-based training situations where trainees can supplement their current skills and learn from the real-life experiences of other employees.

The IRS has also expanded its recruiting efforts. Now twenty-three full-time recruiters support the tax-related and professional recruitment needs of IRS divisions and business functions. This cadre of recruiters works to maintain partnerships with more than 200 colleges and universities and attend campus and commercial events across the country to establish the IRS as an employer of choice.

Question 15

The Committee has requested Treasury and the IRS to submit a credible, comprehensive plan by September 30, 2006 to close the tax gap.

a) To what extent will having a tax gap plan help to close the gap?
b) Are Treasury and the IRS capable of developing a credible and comprehensive plan by September 30, 2006?
c) Describe what such a plan should look like, for example, what priorities, goals, benchmarks and measures do you think should be included in a tax gap plan? Discuss the appropriate allocation of resources among service, enforcement and technology as part of your response.
d) To what extent can existing IRS strategic and action plans regularly prepared by operating divisions and other functions be used toward developing a comprehensive tax gap plan?
e) To what extent can recommendations from the IRS Oversight Board, the National Taxpayer Advocate, the Government Accountability Office, the Treasury Inspector General for Tax Administration, the National Treasury Employees Union and non-governmental stakeholders be used toward developing a comprehensive tax gap plan?

Response

Setting goals, measuring results, and holding executives responsible for results is the most effective way to ensure a plan will achieve the results intended. Trying to close the tax gap without a plan, without measures, and without accountability in not likely to be effective.

The development of a credible and comprehensive plan to reduce the tax gap faces a particularly difficult challenge. The Board has identified six specific activities that should be included in a comprehensive plan to reduce the tax gap. However, some of the most key recommendations, particularly the simplification of the tax code and the use of additional information reporting, require Congressional action. The IRS and Treasury can develop a plan to specific action that the executive branch will take, but such a plan will be missing key pieces that can only be provided by the legislative branch. The Board suggests that the initial plan developed by the IRS and Treasury be considered as an initial step, and that the Senate Finance Committee, along with the House Ways & Means Committee, work with Treasury to take the plan to the next level and incorporate legislative milestones into the plan.

The Board has identified in its testimony, and previously in its FY2007 budget report, the broad elements of a comprehensive program to reduce the tax gap. The strategic plan would ideally address those six elements, and any others deemed necessary to reduce the tax gap. The Board would consider, however, due to reasons described in the previous paragraph, that such a plan must only be considered a first step, and that it is essential that the plan identify a course of future action and responsibilities, to further develop a broad plan that can form the foundation for

broad action by both the legislative and executive branches. Without such a broad commitment to action, the plan will not address the full range of action needed.

Existing IRS strategic and action plans can be and should be incorporated into a broader plan as applicable, but reducing the tax gap requires action on a broader set of issues than can only be addressed by all the members of the tax administration community, both executive and legislative branch organizations, working towards a common goal. Ten years ago, the National Commission on Restructuring the IRS, which included members from Congress, the Administration, and the private sector, made a comprehensive set of recommendations to make fundamental changes in tax administration. Perhaps a similarly constructed task force or study group would be a useful approach to developing a comprehensive plan to reduce the tax gap. The most difficult aspect of the problem would seem to be developing an approach to tax code simplification, given the range of choices available.

No one organization has a monopoly on good ideas to reduce the tax gap, and the organizations referenced in your question could all contribute to a solution, and would seem as reasonable members of a group to develop a plan, as described in the previous paragraph.

Question 16

Please provide the results of the most recent "TIPS" (Trends, Issues, Problems) reports for each IRS operating division and major function.

Response

The Board does not review or approve the annual "TIPS" reports prepared by the IRS Operating divisions and major functions; however, it reviews annual operating performance plans and performance levels during the fiscal year. The IRS is the best source for obtaining the "TIPS" reports; however, the Board could provide information on the annual performance for those measures monitored by the Board.

Question 17

Please provide the most recent Strategic Action Plans for each IRS operating division and major function.

Response

The Board approves enterprise-wide strategic plans such as the IRS Strategic Plan and the Human Capital Strategic Plan. However, the Board does not approve division level Strategic Action Plans. The IRS is the best source for obtaining these more detailed strategic plans.

Question 18

Provide examples of instances when the Treasury and the IRS have developed plans in response to unanticipated circumstances or legislation containing effective dates very soon after the date of enactment.

Response

Two examples come readily to mind, both within the last year. The IRS has been recognized for its contributions in responding to the aftermath of Hurricane Katrina. Not only did the IRS provide needed tax assistance directly to Katrina victims, it also took on unexpected responsibilities for using its call centers and personnel to staff a hot line for victims and their families. It was a tribute to IRS' ability to respond to a totally unexpected crisis. TIGTA has conducted two audits of IRS actions in the aftermath of Katrina and both were very favorable to the IRS. The IRS also very quickly responded to legislative relief for victims that was provided by Congress.

A more recent example is the IRS response to the flooding of its headquarters building at 1111 Constitution. Plans were quickly made and implemented to compensate for the unexpected loss of this space for six months or possibly longer.

Question 19

To what extent do delays in issuing regulations or other guidance, or delays in deciding a legal position on an issue, impact the tax gap? Comment on the appropriate nexus between expedient tax administration and the "right" legal answer to a tax issue, e.g., is it preferable to issue guidance more quickly that meets the needs of 99% of taxpayers rather than deferring guidance for an extended time in order to address the remaining 1% of taxpayers with unique or unusual circumstances?

Response

In general, it is reasonable to postulate that lack of awareness of tax obligations, including regulations, contributes to the tax gap. Developing and promulgating new regulations as the need arises, such as in support of new legislation, would best be done both correctly and completely as soon as possible. Nonetheless, new legislation can be complex and the development and publishing of regulations take time to ensure high quality guidance is published. Regulations, bu their very nature, cannot be developed instantaneously. As an example, much commentary has been written on the complexity of regulations needed to define manufacturing in the American Jobs Creation Act of 2004 (P.L. 108-357).

With respect to the JOBS act, the Treasury Department has said (see Tax Notes, December 7, 2004, *Treasury to Update Business Plan, Publish Guidance Soon*) it would expedite the delivery of guidance by first publishing notices, rather than revenue procedures, revenue rulings, or regulations. Although the roll-out of regulations is not an issue that the Board normally addresses in its governance role, the Treasury approach seems to represent a reasonable balance between the conflicting needs of getting out all the details versus getting information out quickly. In this case, Treasury published a notice of over 100 pages giving guidance and followed up with hundreds of pages of proposed, temporary and final regulations interpreting this provision. This example illustrates the amount of work involved in providing guidance as well as a reasonable approach to publishing guidance on complex issues.

Question 20

The National Taxpayer Advocate testified that examiners participating in the IRS's National Research Program reported that only 3% of the issues resulting in a change in tax liability were the result of "deliberate or intentional" acts, 27% of adjusted issues were identified as computational errors, and 67% were reported to be inadvertent mistakes.

a. To what extent are the examiners' figures reliable?
b. Dr. Mazur and Mr. Brostek commented that it was difficult to tell whether errors that studies had classified as simple mistakes were truly inadvertent. Please provide examples of studies that demonstrate this point.
c. What factors could influence an examiner's characterization of the causes of an adjustment to an issue?
d. What training do examiners receive to identify and characterize the causes of noncompliance?
e. For purposes of the NRP study, provide the definitions of deliberate, intentional, and inadvertent.
f. Please provide an example of the document completed by examiners that contains this information.
g. To what extent is an examiner required to consider penalties if he/she characterizes the cause of an adjustment to be the result of a deliberate or intentional act?

Response

Details of how NRP examiners classified errors they encountered when reviewing tax returns are best answered by the IRS. The Board's understanding is, however, that examiners were asked to make judgments relative to the source of the error, and had to choose between the categories identified in the question. Classifying an error as "intentional or deliberate" seems to represent a very high threshold, and such a classification typically requires follow-up action on the part of the IRS examiner to assert a penalty. In many instances, the taxpayer is not present during the NRP exam, and it can be difficult to determine taxpayer intent in such circumstances. Classifying an error as deliberate or intentional can also raise the level of confrontation with the taxpayer, and it would be reasonable for examiners to give taxpayers the benefit of the doubt except in the most clear-cut of situations.

Question 21

Please provide a current list of all information returns that are matched to tax returns submitted to the IRS for the purpose of detecting unreported income. Identify additional information returns that will begin to be matched within the next 12 months.

Response

Although the Board monitors IRS performance and productivity, it does not gather or review the more detailed information you requested. This information is best obtained directly from the IRS to ensure you are receiving the most current information. Information matching is an important enforcement tool and the Board would be pleased to discuss the broad use of information matching as you may wish.

Question 22

The National Taxpayer Advocate, the GAO and others have recommended a basis reporting regime to reduce noncompliance resulting from incorrectly stated basis amounts.

a) Does the IRS have the ability to match basis amounts reported on an information return with basis amounts reported on a tax return?
b) If the IRS lacks the ability to match basis information, provide the reasons why. Explain what actions are necessary to make such matching possible and how quickly this can be accomplished.

Response

Although the Board believes information on the IRS' ability to compare basis amounts from tax and information returns is best obtained directly from the IRS, the Board is aware that GAO has recently evaluated basis reporting (GAO Report, GAO-06-603, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, dated June 13, 2006) and identified some issues. GAO estimated that 38 percent of individual taxpayers with securities transactions misreported their capital gains or losses in tax year 2001, with almost three times as many mistakes on securities sales (36 percent) than mutual fund capital gains distributions (13 percent). GAO reported that this may be because taxpayers must determine the taxable portion of securities sales' income whereas they need only add up their capital gain distributions, indicating an error prone process and one that is not well understood. Interestingly, among individual taxpayers who misreported securities sales, roughly two-thirds underreported and one-third overreported.

GAO believes that expanding the information brokers report on securities sales to include adjusted cost basis has the potential to improve taxpayers' compliance, help IRS find noncompliant taxpayers, and reduce taxpayer burden, although it would also present challenges and add to brokers' burden.

Given that the IRS estimates that misreporting income from capital assets contributes $11 billion annually to the tax gap, requiring information reporting of basis reporting would seem to be an idea worth considering.

Question 23

Dr. Mazur estimated that 7 million immigrants are on U.S. payrolls, and 75% of them pay employment taxes. Dr. Mazur indicated that the number of these individuals using stolen or false social security numbers is unknown.

a) IRS Publication 4five3five advises individuals to respond immediately to an IRS notice in the event of a tax matter resulting from identity theft. Describe the actions taken by IRS officials when the IRS is notified by an individual that his/her identity has been stolen, resulting in a tax matter. Provide applicable Internal Revenue Manual sections or other internal guidance describing these procedures.

b) Describe the coordination between the IRS and TIGTA to determine the jurisdiction of stolen or fictitious identity cases that impact tax administration. Identify any impediments to such coordination, including IRC section 6103 disclosure issues.
c) How many stolen or fictitious SSN cases have been reported to the IRS during the last five years? How does the IRS track this figure?
d) How many stolen or fictitious SSN cases have been worked by the IRS during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.
e) How many stolen or fictitious SSN cases have been reported to TIGTA during the last five years? How does TIGTA track these cases?
f) How many stolen or fictitious SSN cases have been worked by TIGTA during the last five years? Delineate the results, e.g., convictions (specify the charge); penalties proposed, assessed and collected (specify by penalty type); taxes proposed, assessed and collected; interest proposed, assessed and collected.
g) In the event of a recurring problem, i.e., the same SSN is claimed by more than one taxpayer for more than one year, is the case worked every year or resolved for all future years?
h) Provide the Full Time Equivalents (FTEs) spent on ID theft cases during the last five years by the IRS and TIGTA.
i) To what extent do staffing levels impact on the IRS's, and TIGTA's, ability to work identify theft cases?

Response

The information you requested relates to specific details of IRS operations that the Board does not normally review. To ensure you are getting the most complete and accurate information, the Board believes you should get this information directly from the IRS and TIGTA.

Question 24

Provide an analysis of the benefits and burdens on payers, payees, and the IRS, in connection with increased information reporting and withholding requirements. Include your conclusions and recommendations concerning an appropriate balance of benefits and burdens and the impact on effective tax administration.

Response

The type of analysis requested by the question is best performed by the IRS and the stakeholders involved. The GAO report referenced in the answer to question 22 identified the challenges that both brokers and the IRS would face, and how those challenges could be mitigated, but did not attempt to estimate the burdens and benefits quantitatively. Estimation of such burdens and benefits would require a detailed study. The potential to save up to $11 billion of the annual tax gap is a benefit worth pursuing. In addition, as indicated at the hearing, information reporting would also present an opportunity to significantly reduce taxpayers' burden, even as it was adding to the brokers' burden. It may be far easier for brokers to make this calculation than

taxpayers, and the GAO report indicated that many brokers and mutual funds already track report basis information to many taxpayers, which may help to mitigate additional burden.

Question 25

To what extent would raising public awareness of the importance of complying with tax laws impact the tax gap? Describe ways that raising public awareness could be achieved.

Response

The Board has been collecting data on the factors that influence compliance by conducting surveys of public opinions on tax issues since 2002. One question that the Board asks is how much influence does each of the following factors have on whether you report and pay your taxes honestly? The four factors are:

- Fear of an audit
- Belief that your neighbors are reporting and paying honestly
- 3rd parties reporting your income (e.g., wages, interest, dividends) to the IRS
- Your personal integrity

The response is to be given on a five point scale from very influential to not influential. The percent of respondents rating each factor as having a great deal of influence was 32, 21, 41, and 82 percent, respectively. Thus, personal integrity was more than double that of any other factor. Although the survey measures what people say about integrity, not necessarily how they act on this belief, it is still an important finding

In developing communication strategies with taxpayers, one element of those strategies should be to remind taxpayers of the importance of integrity in making tax decisions, and that applying integrity to tax decisions is a characteristic of a good citizen. It would be unrealistic to expect that such a message would produce overnight results, but a slow transformation of values over time would be a reasonable expectation, and one that could be measured. A long term reduction in the percentage of traffic fatalities involving alcohol has been experienced in this country, and I believe this reduction can be correlated with changing public attitudes about drunk driving.

The Board's survey does not indicate the effect that stressing personal integrity would have on the tax gap. Nonetheless, the other factors on the list, all of which taxpayers claim influence them less, are accepted means of influencing taxpayer behavior. Stressing the importance of personal integrity does not mean developing a separate IRS publication on integrity; a more realistic approach would be to embed messages on the importance of personal integrity in existing IRS channels of communication with the public. The goal would be to slowly change public attitudes over time.

Question 26

The IRS website provides phone numbers and addresses for local IRS offices. Taxpayers are advised they can call a phone number, leave a message, and the call will be returned by the IRS within 2 business days. The Committee recently tested the level of service to taxpayers calling

the IRS. Calls to 25 of these sites yielded only 18 returned phone calls, a 28% failure rate. Of the 18 responses, only one IRS caller suggested visiting the IRS website for information. The most prevalent recommendation by the IRS responders was for the caller to visit the local IRS office for assistance. IRS leadership explains proposed reductions in taxpayer assistance center hours and services are justified because of increased web services.

a) Explain why 28% of the phone calls would not be returned.
b) Explain the apparent disconnect between IRS leadership and front-line employees regarding the use of the IRS website as an information resource for taxpayers.

Response

The Board routinely reviews the timeliness and accuracy of field assistance performance levels. Based on the performance reported by the IRS, the Board does not see the see the same performance shortcomings received by the Committee staff during the test described in the question. The Board respectively defers the more detailed response to this question to the IRS.

Question 27

TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," found that while the IRS has increased its examination coverage rate of high-income taxpayers, the increased coverage largely is due to correspondence examinations. TIGTA reported assessments of $1.4 billion on taxpayers who failed to respond to the IRS during correspondence exams, however, 71% of these assessments remained uncollected after almost 2 years. Given these results, is it efficient to use IRS resources to conduct a correspondence exam that can be ignored by a taxpayer without apparent consequence?

Response

As noted in the response to question 11, the IRS believes that it can reach more taxpayers at a lower cost through correspondence examinations than through more labor-intensive, face-to-face examinations, thereby increasing the coverage rate, and that correspondence examinations are important to ensure compliance. This type of exam focuses on errors and examination issues that typically can be corrected by mail, and are less complex than face-to-face examinations. The TIGTA report does not comment on whether more correspondence examinations are better than fewer face-to-face audits, but does question the merit of correspondence audits if follow-up action is not taken.

The TIGTA report notes that the audit rate for both types of exams has increased. The Board supports IRS efforts to increase the audit rate of high income taxpayers, although it recognizes that the number of correspondence audits has grown at a faster rate. TIGTA has recommended that the IRS complete its plan to maximize the compliance of high-income taxpayer examinations, including the proper mix of audit techniques. The IRS has agreed with that recommendation, and the Board concurs that the determination of the proper mix needs to take potential collectibility into account. However, if correspondence exams are effective, the proper response on IRS' part may be to shift collection resources to reduce the number of assessments

from correspondence audits that go uncollected. This may prove to be an area where private collection agencies can be applied.

Question 28

TIGTA report #2006-30-105, "While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited," indicates that IRS management officials say they are working on a plan to better identify high-income tax returns for examination, including placing less emphasis on non-filers. TIGTA report #2004-30-127, "The Return Delinquency Notice Program Could Be Used More Effectively to Promote Filing Compliance and Reduce the Tax Gap," found that the number of potential individual non-filer cases increased from 6.1 million in 1994 to 8.9 million in 2001, but that IRS resources assigned to these cases had declined. TIGTA observed that the ability of the Return Delinquency Notice Program to effectively promote filing compliance has been significantly affected. TIGTA estimated at least $1 billion in taxes was foregone as a result.

a) Explain the IRS's decision to place less emphasis on high-income nonfilers in light of these TIGTA reports.
b) What impact would deemphasizing high-income nonfilers have on tax administration and the tax gap?
c) Why do so many high-income taxpayers ignore correspondence audits? Is this true for other taxpayer groups, as well?
d) What can the IRS do to increase taxpayer response to correspondence audits?
e) How can the IRS collect tax deficiencies resulting from correspondence audits sooner?

Response

These are important questions but they involve detailed research findings and operational decisions that would best come from the IRS. However, the Board can request the data from the IRS and report its findings to you on this matter, if additional comments are required from the Board. The Board respectively defers the more detailed response to this question to the IRS.

Question 29

TIGTA report #2006-40-067, "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program," found that at least 47 Taxpayer Assistance Centers are understaffed. What plans does the IRS have to ensure that TACs are staffed commensurately with taxpayer needs?

Response

The Board is participating with the IRS in the development of the Taxpayer Assistance Blueprint. Once completed, the blueprint should provide the data needed to better align customer service resources with the needs and expectations of taxpayers.

Question 30

The May 27, 2006 IRS Filing Season Data reports 3,449,641 field assistance walk-in contacts, an 11.1% decrease from 2005. Describe how this count is taken. Are taxpayers who desire services not offered by the TAC included? Are taxpayers who appear outside the hours of service or when the TAC is closed for lunch counted?

Response

Although the Board routinely reviews the timeliness and accuracy of field assistance performance levels, it does not review performance at the level of detail requested in your question. To ensure you receive the most accurate and current information, the Board respectively defers the more detailed response to this question to the IRS. The Board would be pleased to have follow-up discussion with you on the information provided by the IRS.

Question 31

To what extent do concerns about the tax gap impact on the IRS's initial budget request to Treasury? For example, when preparing its budget request, does the IRS identify the scope of the tax gap problem and ask for resources commensurate with the size of the gap? Does the size of the tax gap influence the "pass backs" from Treasury and OMB?

Response

When briefing the Board on its budget request for FY2008, the IRS noted that concerns about the tax gap did impact the budget request, but for FY2009, it intended to let the tax gap drive the budget request in a more formal way.

As can be seen in its FY2007 budget report to Congress, the Board was influenced by the size of the tax gap in making its recommendations. That was the purpose for including a section in the budget report that identified the Board's recommendations on the elements of a comprehensive strategy to reduce the gap. In the Board's opinion, more needs to be done to reduce the gap, and its budget recommendations reflected this belief.

In considering its FY2008 budget recommendations to the Treasury Department, which will be published by the Board in February/March 2007, the Board put similar importance on reducing the tax gap. The Board is hopeful that the Treasury Department and OMB will put similar importance on the tax gap when formulating the President's budget request.

From Senator Kerry

Question 1

What concrete steps should be taken to improve voluntary compliance?

Response

In the Board's testimony and its FY2007 budget report to Congress, the Board has concluded that there is no one "silver bullet" that can be implemented that will solve the problem. Rather, it believes that reducing the tax gap requires a comprehensive set of strategies with action on many fronts—from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

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

The first recommendation is to simplify the tax code. Our complex and ever-changing tax code not only confounds honest taxpayers who want to comply with their obligations under the law, but provides ample opportunity for those who exploit its complexity to cheat.

Second, the Oversight Board recommends improved information reporting and enforcement tools to address large areas of the tax gap related to what has been called the cash economy. Although the Board is prohibited by statute from endorsing any specific proposal, we note that in its FY2007 budget submission, the Administration makes several legislative recommendations to close the tax gap that include: (1) increasing information reporting on payment card transactions; and (2) expanding information reporting to certain payments made by federal, state and local governments to procure property and services. They certainly merit congressional discussion and consideration, and Congress has authorized three-percent withholding on payments for property and services made by the federal government and other governmental entities beginning in 2011 in the Tax Increase Prevention and Reconciliation Act of 2005. The National Taxpayer Advocate also recommended in her 2005 Annual Report to Congress that the IRS create a cash economy program office, similar to the Earned Income Tax Credit program office.

There is no shortage of ideas for tax code simplification and improved enforcement tools. Both require legislative actions and are clear examples of solutions that require coordinated action by the legislative and executive branches. As more taxpayers are potentially affected by the Alternative Minimum Tax, the case for simplification will increase even more.

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

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

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

Fourth, the IRS should conduct research that will allow it to more effectively target areas of major non-compliance. The Board recommends that the IRS develop a long-range strategic plan for research that goes beyond the current 2009 end date for the IRS Strategic Plan. In such a plan, the IRS should describe how it will bring its research on all taxpayer segments up to date, and perform a limited sample every year so that its research on all segments will be as current as possible. The Board also recommends that the IRS conduct research on the impact of customer service on voluntary compliance and the service needs of taxpayers.

Research on taxpayer compliance will aid the IRS in implementing measures to evaluate its progress in reducing the tax gap. Without a reliable way of measuring the compliance more quickly, it will be difficult to measure progress to reduce the gap.

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

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

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

Sixth, there must be more emphasis on personal integrity in making tax decisions. The Board has found that the vast majority of taxpayers state that their personal integrity is a very important factor in influencing their tax compliance. In the Board's most recent Taxpayer Attitude Survey, 82 percent of taxpayers cite personal integrity as the principal factor for reporting and paying their taxes honestly. Board surveys since 2001 have consistently showed that the public says that personal integrity is much more important than fear of an audit or information reporting in influencing them to report and pay their taxes honestly. Our tax administration system should challenge taxpayers and preparers to be conscious of the need for integrity when making tax decisions, and maintain the highest standards of compliance.

Question 2

Is the underreporting of income the biggest contributor to the tax gap and if so, are there ways to significantly improve reporting that are not burdensome and costly for small businesses?

Response

Underreporting of individual income tax accounts for $197 billion of the $350 billion gross annual tax gap. The Administration and National Taxpayer Advocate have both made recommendations for increased information reporting of income, and both believe the additional burden imposed on small business would be small compared to the benefits received. As discussed at the hearing, it is possible that additional information reporting will reduce the burden on the individual taxpayer. The Board believes that the Administration and National Taxpayer Advocate recommendations have merit and warrant consideration by Congress.

Question 3

In a new report, the Treasury Inspector General for Tax Administration has criticized lapses in IRS security measures to protect against unauthorized access to returns. What is being done to address this?

Response

The Board recently heard from the Director, Mission Assurance at its February 2006 Board meeting. He described the IRS Security program, identified the major material weaknesses that have been reported in the IRS' program, and described the IRS accomplishments in resolving those weaknesses. The Board will hold the IRS accountable for resolving all their major material weaknesses, which encompass a broad range of security issues. Details of the IRS plan to protect against unauthorized access is best obtained from the IRS.

Question 4

What percent and amount of the tax gap can be contributed to the earned income tax credit (EITC)? What percent of audits is conducted on EITC filers?

Response

The Board uses tax gap data in its strategic decision making and to support its annual budget recommendations. It does not gather and review tax gap data at the program level and does not have data on the percentage of the tax gap created within the EITC program. To get the most accurate and complete information you requested, the Board respectively defers the detailed response to this question to the IRS.

Question 5

In a new report, the Treasury Inspector General for Tax Administration indicates that 70 percent of the assessments on high-income taxpayers have not been collected. Why has this happened and what can be done to improve collection rates?

Response

The TIGTA report in question, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited,* report # 2006-30-015, states that the IRS believes it can reach more taxpayers at a lower cost through correspondence examinations than through more labor-intensive, face-to-face examinations, thereby increasing the coverage rate. It notes that correspondence examinations are important to ensure compliance, but they focus on errors and examination issues that typically can be corrected by mail. Thus, they are less complex than face-to-face examinations.

The report also states that the IRS made assessment of $1.4 billion on taxpayers who did not respond to the IRS during correspondence exams. TIGTA estimated that approximately $1.2 billion of this $1.4 billion has been either abated or not collected almost two years after the date of the assessment. Given this high amount of uncollected assessments, TIGTA questioned whether the examination program for high income taxpayers was positively affecting compliance trends.

Although the report sheds some light on IRS' examination program, without knowing the impact the examination program has on taxpayer compliance, the effectiveness of the examination program cannot effectively assessed. The Board has recommended additional funding for IRS research so it can be made an on-going program. Such a change would improve the ability of the IRS, as well as oversight groups, to assess the impact enforcement has on compliance.

The TIGTA report notes that the audit rate for both types of exams has increased. The Board supports IRS efforts to increase the audit rate of high income taxpayers, although it recognizes that the number of correspondence audits has grown at a faster rate than face-to-face examinations. TIGTA has recommended that the IRS complete its plan to maximize the compliance of high-income taxpayer examinations, including the proper mix of audit techniques. The IRS has agreed with that recommendation, and the Board concurs that the determination of the proper mix needs to take potential collectibility into account. However, if correspondence exams are effective, the proper response on IRS' part may be to shift collection resources to reduce the number of assessments from correspondence audits that go uncollected. This may prove to be an area where private collection agencies can be applied.

Question 6

What percent of audits are conducted on high-income taxpayers?

Response

The report referenced in the previous question states that the examination coverage rate of high-income taxpayers increased from 0.86 percent in Fiscal Year (FY) 2002 to 1.53 percent in FY 2005. Included in this statistic is an increase in the examination coverage rate of high-income tax returns, U.S. Individual Income Tax Returns (Form 1040) with a Profit or Loss From Business (Schedule C). This examination coverage rate increased from 1.45 percent in FY 2002 to 3.52 percent in FY 2005. The report does note, however, that the increase in examination coverage is due largely to an increase in correspondence rather than face-to-face examinations.

While face-to-face examinations increased by 25 percent from FYs 2002 through 2005, correspondence examinations increased by 170 percent over the same period.

As a result, the percentage of all high-income taxpayer examinations completed through the Correspondence Examination Program grew from 49 percent in FY 2002 to 67 percent in FY 2005. The increase in correspondence examinations for high-income taxpayers who filed a Schedule C was even larger. Examinations closed by correspondence comprised about 30 percent of all high-income taxpayer Schedule C examinations from FYs 2002 through 2004. In FY 2005, approximately 54 percent of all high-income taxpayer Schedule C examinations were conducted by correspondence.

The IRS can provide more detailed information on its high income examination program, and break down the audit rate for taxpayers with adjusted gross income over $100,000 to greater levels of detail.

COMMUNICATION

STATEMENT OF COLLEEN M. KELLEY

NATIONAL PRESIDENT

NATIONAL TREASURY EMPLOYEES UNION

ON

A CLOSER LOOK AT THE SIZE AND SOURCES OF THE TAX GAP

SUBMITTED TO

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
SENATE FINANCE COMMITTEE

JULY 26, 2006

Chairman Kyl, Ranking Member Jeffords, and members of the Subcommittee, my name is Colleen Kelley and I am the National President of the National Treasury Employees Union (NTEU). As you know, NTEU represents 150,000 federal employees in 30 federal agencies and departments, including the men and women who work at the Internal Revenue Service. I appreciate your initiative in holding this hearing on an issue of major importance to taxpayers across the country, the tax gap. Many of our workers handle responsibilities on a daily basis that revolve around closing the tax gap, and I am pleased to submit this statement to the subcommittee offering our input.

As you know, the tax gap is the difference between the amount of tax that should have been paid and the amount that was actually received by IRS in a given tax year. In April of this year, the IRS reported that the gross tax gap is estimated to be approximately $345 billion. (IRS Updates Tax Gap Estimate," IR 2006-028, www.irs.gov/newsroom/). This is a sizable debt owed to the government but one that can be addressed. In his testimony before the Senate Budget Committee in February of 2006, Comptroller General of the United States, David Walker, pointed out that even modest progress on the tax gap would likely yield significant revenue. Each 1 percent reduction could yield $3 billion annually (GAO) 06-453T).

Additional Staffing Required

My message on the tax gap is simple: the IRS needs more employees on the frontlines of tax compliance and enforcement to help it close the $345 billion tax gap. It also needs a dedicated funding approach which I will address later in this statement. Rather than move forward with its plans to drastically cut customer service in order to expand its enforcement role, the IRS needs to strike a balance between offering adequate opportunities for taxpayers to voluntarily comply and enforcing the tax code. NTEU agrees with GAO's earlier finding on in its tax gap report (GAO-05-753) that a more regular compliance assessment is needed if the IRS wishes to obtain a clearer picture of the extent of the tax gap. But I would emphasize that the IRS should determine those factors which encourage and enable taxpayers to voluntarily comply as well as determine reasons for noncompliance.

The bottom line is the IRS has the expertise to improve compliance but lacks the necessary personnel. Thus far, it can point to successes in increased collections of delinquent tax debt. The President's own fiscal 2007 budget proposal trumpets in several places the increased tax collections produced by IRS's own employees (without the use of private collection agencies). For example, it mentions the increased collections of delinquent tax debt from $34 billion in 2001 to $47 billion in 2005, an increase of 38 percent". (Pages 227, 233 of FY 2007 Budget). In its FY 2006 Budget in Brief, the Treasury Department acknowledged the IRS "Collected more than two trillion dollars in revenue with $47.3 billion collected through enforcement activities, a 10 percent increase from FY 2005". (p. 62)

Despite these accomplishments, front line workers are thinly spread and are submerged with handling day-to-day responsibilities while also facing serious job security concerns. Just two days ago, the *New York Times* ran a story titled, "IRS to Cut Tax Auditors" which details a planned reduction of 157 estate tax lawyers – almost half of the agency's estate tax lawyers -

who audit some of the wealthiest Americans. These Americans are subject to the gift and estate taxes which, as you know, only touches the very affluent. Finding a mistake in these returns can often produce several thousand dollars per return. It makes no sense for IRS to be eliminating key workforce positions in an area that could produce significant revenue to help close the tax gap.

While NTEU agrees with IRS' goal of enhancing tax compliance and enforcement, we don't agree with the approach of eliminating front-line customer service employees in order to pay for additional compliance efforts. As the number of tax returns continues to grow, the number of IRS employees continues to shrink. As the Oversight Board pointed out in its 2003 Annual Report, IRS workload has increased by 16 percent while at the same time the number of full time equivalent employees has decreased by 16 percent from 1999 to 2002. According to the 2004 IRS Data Book, the number of IRS employees dropped from 106,642 in 1996 to 98,735 in 2004.

The problem of the shrinking workforce is exacerbated by a number of factors, including an increasingly complex tax code and a high number of tax returns—paper as well as electronic returns. This has led to a serious decline in the ability of the IRS workforce to handle increasing demands. Combined Collection and Examination function enforcement staff declined from 25,000 at the beginning of FY 1996 to 16, 000 at the end of FY 2003, a 36 percent decline.

In its FY 2006 IRS Budget/Special Report, the IRS Oversight Board stated that it "agrees that investing in enforcement does pay for itself many times over, not only in increased revenues but by reinforcing the belief that all taxpayers are paying their fair share." In its FY 2007 Special Report, the Oversight Board recommended an increase in FTEs to prevent tax gap growth including 748 FTEs to "address the tax gap associated with small business and self-employed taxpayers"...86 FTEs to "curtail non-compliance in abusive schemes, corporate fraud, non-filers, employment tax and Bank Secrecy Act," and 62 FTEs "to address fraudulent payments made through the EITC program." (p.22)

Also, the IRS should look at the management to bargaining unit employee ratio to find much needed resources for additional collection work. Although the number of frontline employees who do the work at the IRS has decreased by 5.1 percent since 2000, the number of managers who supervise these employees has *increased* by 1 percent over this same period. If the IRS decreased the number of managers and management officials at the same rate as it has decreased its rank and file employees, the Agency could put the savings toward bolstering Collections work.

Experiencing an increase in workload while witnessing a downturn in personnel has taken its toll on some functions. In its September 2003 report, the Treasury Inspector General for Tax Administration (TIGTA) indicated that the Automated Collection System (ACS) function was a "critical Collection operation," collecting nearly $1 million per FTE in FY 2002. ACS is a system that is operational in 10 service centers to allow the IRS to contact taxpayers by telephone and collect delinquent taxes.

It is our understanding ACS staff is at the current time so overwhelmed with incoming call responsibilities, they simply do not have the manpower to make basic outgoing calls to collect taxes. This is an obvious area where increased staffing could help lower the tax gap.

Customer Service

Congress must continue to reject IRS' plans to implement draconian cuts to customer service. Customer service is one half of the compliance equation. The IRS' plan to close 67 Taxpayer Assistance Centers (TACs) across the country last year was counterproductive to the mission of the IRS. This plan will exacerbate—not shrink—the tax gap. IRS Taxpayer Assistance Centers are taxpayers' frontline source for personal, face-to-face tax help. Taxpayers who have complex issues, need to resolve a tax problem, or are more comfortable talking with someone in person can visit a local Taxpayer Assistance Center. IRS representatives in these offices can help with inquiries or adjustments to tax accounts, payment plans for those who owe tax and cannot pay the full amount, questions about IRS letters and notices, and levies on wages or bank accounts.

Seniors, who rely on face-to-face contact more than younger taxpayers, will be forced to travel farther distances in order to get the tax assistance they need if the IRS follows through with its cuts to customer service. This also means that minorities and low-income taxpayers, who rely on the Centers to help with language barriers, the earned-income tax credit and general tax preparation, will also see the tax services they rely on cut.

Last year, the Treasury Inspector General for Tax Administration Russell George stated before the Senate Transportation, Treasury, HUD Appropriations Subcommittee (April 7, 2005), "TIGTA believes this information is insufficient to draw conclusions on the capability and likelihood that taxpayers who have used these centers in the past will be willing to use alternative methods of seeking help, such as the internet or telephone. I strongly recommend that the IRS further research these issues before closing TACs."

The 2004 IRS Oversight Board Tax Compliance Study found that "the most heavily relied upon source of tax information and advice are IRS representatives" (82 percent see them as very/somewhat valuable). The study further shows that more than 90 percent of those surveyed said that IRS customer service is either very or somewhat important to them.

The statements from these reliable sources point to one conclusion: maintain customer service options for taxpayers. Both chambers of Congress also came to same conclusion with the language passed in H.R. 3058, the Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006 which temporarily prevents cuts to customer service. Customer service is a critical part of the compliance equation and the IRS must not be allowed to slash customer service this year, or next year, for the sake of bolstering enforcement.

Private Tax Collection

NTEU strongly opposes the Administration's plan to privatize IRS tax collection, as authorized by Congress in the American Jobs Creation Act of 2004. Under the statute, the IRS would be permitted to hire private sector debt collectors and pay them a bounty of up to 25 percent of the money they collect. NTEU opposes this short-sighted proposal, anticipates its complete failure as witnessed in a similar 1996 pilot program and will continue to work towards its repeal.

The House has twice signaled its bipartisan disapproval of privatizing tax collections by passing legislation that would prevent the program from moving forward. This year, in its FY 2007 Treasury Transportation appropriations bill, an amendment offered by Rep. Steven Rothman (D-NJ) received bipartisan support and was included in the House-passed bill to bar IRS from spending funds on the tax collection program.

Representatives Rob Simmons (R-CT) and Chris Van Hollen (D-MD) introduced H.R. 1621, The Taxpayer Protection Act of 2005. The legislation would repeal the IRS' recently enacted authority to hire private debt collectors to collect tax debt. The bill currently has 78 bipartisan cosponsors. The Taxpayer Protection Act would undo a serious mistake and NTEU strongly supports this legislation.

Proposals to allow private collection agencies to collect taxes on a commission basis have been around for a long time. As far back as 1986, the Reagan administration opposed the concept of privatizing tax collections. The Treasury Department warned then of considerable adverse public reaction to such a plan, and emphasized the importance of not compromising the integrity of the tax system, which is a longstanding inherently governmental function. President Reagan's Administration said this about such a proposal:

> *"The Department strongly opposes contracting out the collection of taxes because it is likely to result in considerable adverse public reaction. The public must be assured at all times that the person collecting taxes derives no personal benefits from that activity and that the integrity of the tax system will not be compromised." (Treasury Department Statement to the House Judiciary Committee, August 8, 1986).*

The IRS' proposal would risk the loss of confidentiality of millions of taxpayers' private information, would provide incentives for the use of abusive tactics by private debt collectors, and would cost U.S. citizens much more money than if IRS employees did the job. A two-year pilot project in 1996 was so unsuccessful it was cancelled after one year. The pilot project lost money, did not provide adequate protection of sensitive taxpayer data and allowed hundreds of taxpayers to be called outside of the times set by the Fair Debt Collection Practices Act—including calls at 4:19 a.m. (IRS Internal Audit Report No. 080805, December 19, 1997).

The National Taxpayer Advocate Nina Olson has also expressed her concerns about handing this work over to private collection agencies (PCAs) in lieu of keeping it in-house. In her "Fiscal year 2006 Objectives Report to Congress" Ms. Olson stated, "the National Taxpayer Advocate has significant concerns about supplanting the trained professionals at the IRS with private debt collectors. A primary concern is the quality and quantity of training received by IRS

employees versus the training received by private collection representatives." Although the IRS has attempted to convince skeptics that the PCAs will receive adequate training, you simply cannot compare the years of dedicated service and successful performance of IRS employees to the temporary jobs of private collection agency employees. No amount of training can replace the institutional knowledge and respect for tax compliance and enforcement exhibited by IRS employees.

Dedicated Funding Stream

If the Congress is serious about eliminating the tax gap, my second message is it should enact a dedicated funding stream to hire IRS personnel outside of the ordinary budget process. There is precedent for this in IRS enforcement.

One of the most often heard arguments in favor of the use of private collection agencies is that if they are paid out of the proceeds of what they collect; it increases the IRS' enforcement capabilities without having to increase appropriations. Numerous Congressional supporters said they would prefer to have tax collection done by federal employees, but would go along with the use of private collection agencies solely because it avoids the difficult issue of getting Congress to approve additional appropriations for the IRS.

The statute that gives the IRS the authority to use PCAs allows 25 percent of collected revenue to be returned to the collection companies as payment and 25 percent to be retained by the IRS for enforcement efforts, thereby circumventing the appropriations process altogether.

There is nothing magical about revenues collected by private collection companies. If those revenues could be dedicated directly to contract payments and IRS enforcement efforts, there is no reason some small portion of other revenues collected by IRS employees couldn't be dedicated to IRS enforcement efforts. This would allow for increased enforcement by IRS employees, which most people indicate is the preferable route and eliminate large payments (up to 25% of collections) to private collection companies, significantly increasing net revenue to the General Treasury. While legislation would be required to allow for this kind of dedication of revenue, I believe the precedent has now been set with the private collection agency funding provisions. Congress should consider supporting this approach as a common sense way to make real progress in closing the tax gap, lowering our deficits and making more funding available for our Nation's critical needs.

Flawed Revenue Scoring

It is NTEU's position that calculations by the Joint Tax Committee, Congressional Budget Office (CBO) and OMB to "score" the revenue impact of the private debt collection initiative were seriously flawed and should be revisited. The Joint Committee on Taxation's October 4, 2004 calculation entitled, "Budget Effects of the Conference Agreement for H.R. 4520, the 'American Jobs Creation Act of 2004' Fiscal Years 2005 – 2014," (JCX-69-04) claims that $1.35 billion in revenues will be raised over a *ten year* period by private debt collectors at a cost of $339 million in outlays. In other words, the government will *pay* nearly $400 million to *possibly get* these revenues down the road.

Aside from the serious questions I have discussed about the shortcomings of the privatization proposal, it is my understanding that the Congressional Budget Office (CBO) and others generally do not score revenue in cases in which no new tools or enforcement authority has been provided to an agency. Since the debt collectors' proposal simply allows IRS to contract with collection companies and does not provide those companies with enforcement tools, Congress should not count future revenues raised for its budgetary purposes. However, in this scoring report, $1.35 billion over 10 years is counted. CBO does not score changes in revenues each time Congress changes funds appropriated to the IRS for staffing. Yet, by counting revenue potentially collected by debt collectors while not counting IRS's revenue raised, the committee is setting up a double standard.

It is time to stop budget gimmicks of this nature. It is clear that dollars spent on IRS compliance efforts return exponentially more to the Treasury. We must create a process that provides those dollars regardless of arcane congressional budgeting rules if we are going to make progress on closing the tax gap.

IRS Commissioner Everson has confirmed in congressional testimony that it is less costly to use IRS employees than private collection agencies. To waste taxpayer dollars in this way defies common sense and when budget scoring rules promote this waste they must be changed.

Conclusion

Frontline IRS employees are the best defense against an increasing U.S. tax gap. But it is up to Congress to provide the funding necessary for these employees to do their job. Then, it is up to the IRS to utilize these employees to their fullest potential. Without a doubt, rank and file employees are committed to working with management to increase efficiency and customer satisfaction while decreasing the U.S. tax gap.

If Congress is serious about lessening the tax gap, it will provide IRS with the necessary staffing and a dedicated funding stream to support those additional workers.

I thank you for holding this important hearing today. NTEU supports and offers assistance in your mission to shrink the U.S. tax gap.